[redacted], Chief of the Economics Division

[redacted] Senior Financial Economist (former)

Office of the Air Force Chief of Staff

General John Jumper,

Office of the Air Force Deputy Chief of Staff for Air and Space Operations

Mr. Harry Disbrow, Assistant Director of Operational Capabilities Requirements

Office of the Air Force Deputy Chief of Staff for Installations and Logistics

[redacted] Action Officer for Weapon Systems Division, Aircraft Maintenance Directorate

[redacted] Action Officer for Weapons Systems Division, Aircraft Maintenance Directorate

Office of the Air Force General Counsel

Mr. James "Ty" Hughes, Office of the Deputy General Counsel (Acquisition)

Office of the Air Force Legislative Liaison

[redacted] Chief of Programs and Legislation (retired)

[redacted] Chief of the Force Structure Branch

[redacted], Legislative Liaison

Air Force Air Mobility Command

Lieutenant General Arthur Lichte, Director of Plans and Programs (former)

[redacted] Chief of Systems Requirements

[redacted] Chief of Tanker Requirements (former)

[redacted] Chief of Tanker Requirements (former) b(6)

[redacted] (A58T), Chief of Tanker Requirements (former)

[redacted] Chief of Tanker Requirements

[redacted] Chief of Tanker Requirements (former)

[redacted] Air Refueling Program Manager for the Tanker Requirements Branch

[redacted] Senior Analyst Studies and Analysis Division

[redacted] Chief of Studies and Analysis Division

[redacted] Science Applications International Corporation KC-135 Tanker Requirement Manager

[redacted] Requirements and Planning Council Analyst

[redacted] Program Analyst for the Next Generation Tanker program

[redacted] Program Analyst for Tanker Requirements Branch

Air Force Program Executive Office, Aeronautical Systems Command, Air Force Materiel Command

Brigadier General Ted Bowlds, Program Executive Officer for Strategic Programs

[redacted] System Program Director, KC-767 System Program Office

[redacted] Deputy Director, KC-767 System Program Office

[redacted] Contracting Officer

[redacted] Office of the Staff Judge Advocate

[redacted] Contracting Officer

[redacted] Logistics Manager

[redacted] Contracting Officer

[redacted] Cost Price Analyst

[redacted] Chief of Air Force Vehicle Integrated Product Team

[redacted] Deputy Chief of Contracting

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[redacted] Supervisory Cost Analyst

Oklahoma City Air Logistics Center, Air Force Materiel Command

Lieutenant General Charles Johnson, Commander

[redacted] Director of Maintenance (retired)

[redacted] Vice Commander

[redacted] Director of the KC-135 System Program Office

[redacted] Chief of Aircraft Maintenance

[redacted] Deputy Chief of Tanker Aircraft Maintenance Branch, Maintenance Division

[redacted] Executive Officer for the Director of Maintenance

[redacted] Executive Officer for the Director of Maintenance

[redacted], Deputy Director of Staff

Mr. Robert Conner, Executive Director

[redacted] Tanker Branch Planning Chief

[redacted] Chief Engineer of the KC-135 System Program Office

[redacted] KC-135 Weapons Systems Support Center Chief

[redacted] Director of Staff

[redacted] Director of Engineering

[redacted] Deputy Chief of Aircraft Maintenance

[redacted] KC-135 Industrial Engineering Technician

[redacted], Systems Engineering Division Chief for the KC-135 System Program Office

[redacted] Deputy Director of Maintenance

[redacted] Chief of Procedures and Analysis for the KC-135

[redacted] Sustainment Division Chief for the KC-135 System Program Office

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[redacted] Deputy Director for the KC-135 System Program Office

[redacted] Structural Engineer for the KC-135 System Program Office

[redacted] Production Management Specialist for the Procedures and Analysis Branch

[redacted] Tanker Branch Chief, Aircraft Division

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Defense Science Board

William Schneider, Jr., Chairman of the Defense Science Board

Appendix E. Operating Leases

The following discusses the use of commercial financing to recapitalize the Air Force KC-135 tanker aircraft fleet with Boeing KC-767A tanker aircraft; the concerns of the congressional budget committees, the Office of Management and Budget, and the Congressional Budget Office about various financing schemes involving lease-purchase arrangements; and the approval process for the Boeing KC-767A tanker aircraft operating lease.

Using Commercial Financing to Recapitalize the Air Force KC-135 Tanker Aircraft Fleet with Boeing KC-767A Tanker Aircraft

Senior members of the Administration, Congress, the Department of Defense, and the Air Force worked together in an effort to use commercial financing, an operating lease, to start recapitalizing the Air Force aerial tanker fleet with Boeing KC-767A tanker aircraft. The purpose of the operating lease was to preserve budget authority for other higher priority items because the Air Force did not have money in the budget to purchase tanker aircraft. The use of an operating lease to begin recapitalizing military assets is an issue that needs to be clearly addressed by the Administration, Congress, and DoD to prevent future problems.

Office of Management and Budget Circular Nos. A-11, "Preparation, Submission, and Execution of the Budget (2003)" and A-94, "Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs," provide specific requirements that must be met to qualify for an operating lease. Senior members of the Office of the Assistant Secretary of the Air Force (Acquisition) consistently argued it was their opinion that the Boeing KC-767A Tanker Program met the Office of Management and Budget criteria for an operating lease; however, the Office of Management and Budget, the Congressional Budget Office, congressional staff, the Department of Defense Office of Program Analysis and Evaluation, the Department of Defense Office of the Inspector General, and other Air Force officials had different opinions. Subsequently, the Office of Management and Budget changed its A-11 criteria to where the tanker lease program would no longer qualify. Further, some of the actions taken to "make the lease fit" were highly questionable such as:

- paying 90 percent of the assets fair market value over 6 years for a 25 to 40-year asset;
- selling the tanker aircraft at fair market value and then receiving a refund for the difference between the fair market value and the remaining 10 percent value after 6 years;
- waiving termination liability for the lease peaking at over [redacted] and b(4)

- using a multiyear aircraft lease price and a non-multiyear buy price for the A-94 net present value analysis.

Congressional Budget Office Paper on the Use of Leases and the Relationship to the Budget

The congressional budget committees, the Office of Management and Budget, and the Congressional Budget Office have historically had concerns with various financing schemes involving lease-purchase arrangements because they understate the cost of capital acquisitions in the budget. When lease-purchases are not appropriately scored in the budget, managers may be encouraged to purchase assets that were lower priority and that could not otherwise compete in the budget process.

A Congressional Budget Office paper, "The Budgetary Treatment of Leases and Public/Private Ventures," examined agencies' use of leases and the relationship to the budget. The Congressional Budget Office paper showed that in the late 1980s, the congressional budget committees, the Office of Management and Budget, and the Congressional Budget Office have been concerned with the proliferation of lease-purchases. In October 1988, the Acting Director, Office of Management and Budget told the heads of the executive departments and agencies that, although "a number of agencies and committees of Congress have proposed financing schemes involving lease-purchase arrangement," those arrangements understated the cost of capital acquisitions in the budget and were opposed by the Administration. The Congressional Budget Office paper reported that the demand for budgetary treatment, which would consistently put the costs of lease-purchases up front in the budget, reflected three basic concerns:

- One was that the ability of agencies to rely on private borrowing, albeit private borrowing backed by future lease payments by the government, had the potential to seriously undermine fiscal discipline, rendering limits on deficits or caps on federal spending ineffective.

- Second was the concern that the ability of agencies to avoid the up-front costs of their decisions could make it more likely that they would undertake projects of lower priority, leading to an inefficient allocation of resources.

- The third concern was the incentive to use lease-purchases even though a lease-purchase was almost always more costly than direct purchase of the same asset.

The Congressional Budget Office paper also addressed other lease issues.

> Rapid growth in the use of lease-purchases in the 1980s highlighted the need for up-front scoring of those leases that amounted to asset purchases. In response to budgetary pressures, federal managers increasingly relied on such leases even though, viewed over the life of the asset, they were almost always more costly than outright purchases. In addition, the extensive use of leases threatened to undermine efforts to control total federal spending. The guidelines for the budgetary

treatment of leases that accompanied the Budget Enforcement Act [BEA] of 1990 were expected to curb the rapid growth of leasing, promote fiscal discipline, and encourage more cost-effective choices between leases and outright purchases.

Although the BEA guidelines for leases were adopted in response to the specific budgetary problems of the 1980s, they might be viewed as part of a gradual and sometimes erratic shift toward a budget process that provides greater visibility and control over federal spending. Evidence of that shift is seen in the 1967 Commission on Budget Concepts, which set out the basic principles of federal budgeting, and late in the Congressional Budget and Impoundment Control Act of 1974, which gave the Congress the ability to set revenue and spending targets and monitor progress toward those targets. OMB's current guidelines for the full funding of investments—which initially applied only to the Department of Defense's acquisition of weapons systems but now are applied much more widely—are consistent with that trend.

Under current budgetary guidelines, leases fall into three distinct categories: operating leases, lease-purchase, and capital leases. Operating leases are limited ones that are not considered the equivalent of an asset purchase. As defined in the current scorekeeping guidelines, operating leases satisfy six criteria. Those criteria include a limit on total amount spent on the lease (90 percent of the asset's fair market value) and a limit on the portion of the useful service life of the asset covered by the lease (75 percent). Because operating leases are not equivalent to an asset purchase, the budget authority for such leases is scored either for the full amount of future lease payments up front or, if the contract includes a cancellation clause, for the first year's payment plus any cancellation penalty, with future years' payments scored incrementally over the term of the lease.

In contrast, the budget authority for a lease that fails to meet the criteria for an operating lease is scored up front for the full present discounted value of all future lease payments, regardless of any cancellation clause. Scoring the budget authority up front in this way acknowledges that such leases are, in effect, a commitment to purchase an asset on the installment plan. Such leases are either lease-purchases—leases in which the ownership of the asset transfers to the government at the end of the lease—or capital leases, a category that includes all leases that are neither operating leases nor lease-purchases.

Before the implementation of the current lease-purchase guidelines in 1991, OMB's standard practice was to record the budget authority and outlays for lease-purchases that were specifically exempted from the Anti-Deficiency Act in their authorizing legislation incrementally, over the term of the lease. That approach made lease lease-purchases appear much less costly, in the near term, than direct purchases of assets. In some cases, that budgetary treatment encouraged managers to purchase assets that were lower priority and could not otherwise compete in the budget process. It also encouraged managers to use lease-purchases even if a direct purchase would have been more cost-effective.

Summary of How the Operating Lease Was Approved

The following are selected e-mails, memorandums, and interviews that identify accountable officials associated with the operating lease for the Boeing KC-767A tanker aircraft and excerpts from interviews that representatives from the Department of Defense Office of the Inspector General conducted of senior

Office of the Secretary of Defense and Air Force officials associated with the operating lease.

Prior to 2001. A Senator and the Senate Appropriations Committee encouraged the Air Force to lease airplanes. Specifically, a Senator was pushing to lease airplanes for the Air Force from Boeing for the VCX program.[7] The Air Force entered negotiations, but never leased the planes because of problems involved in the lease process. The Air Force did lease 737s but it was a lot easier deal because Boeing financed them and they were not new airplanes. A Senator and the Senate Appropriations Committee have been trying to encourage the Air Force to lease airplanes.

Early 2001. A Senator called Ms. Druyun, Principal Deputy Assistant Secretary of the Air Force (Acquisition and Management) about acquiring airplanes from Boeing and using leasing because the Air Force did not have the money in the budget. Specifically, a Senator called Ms. Druyun indicating that he was again looking to acquire airplanes for the Air Force. The Senator was really pushing leasing. The Air Force needed to lease the aircraft because it did not have money in the budget to purchase them and was not willing to give up other programs for those aircraft. The Senator was thinking that Boeing would have excess capability after September 11, 2001, and as a result, the Air Force could get a good deal from Boeing. [redacted] Deputy Chief, Contracting Operations Division, Office of the Assistant Secretary of the Air Force (Acquisition) stated that the Senator thought that the DoD budgeting system did not work well and that DoD was going to need additional military capability. In addition, he stated that the Senator thought that the Defense budget was going to go up in the future and that leasing was a way to get programs going. b(6)

May 2001. On May 11, Secretary of Defense Donald Rumsfeld asked Dr. Dov Zakheim, Under Secretary of Defense (Comptroller) to look into commercial financing concepts relating to capital asset leasing and mentioned a Senator's strong interest in facilitating such financing. One of the potential capital asset lease concepts discussed was the replacement aerial tanker for the KC-135 tanker aircraft. The use of lease financing did not require additional budget authority. Specifically, on May 11, 2001, Secretary of Defense Rumsfeld asked Dr. Dov Zakheim to "initiate the process to get this moving and coordinated" relating to a paper on commercial financing concepts of capital asset leasing. The paper was outlined in a May 8, 2001, memorandum that Mr. William Schneider, Jr., Chairman, Defense Science Board, prepared at the suggestion of Mr. Steve Friedman, Chairman, National Economic Council, who met with finance specialists at Citicorp (New York) to:

- brief Citicorp on DoD interest in applying commercial financing techniques to selected DoD assets, including a replacement aerial tanker for the existing fleet of 500 KC-135 tanker aircraft, and

[7] The VCX program consisted of small and large aircraft. The small VCX (C-37A) was a long range executive passenger jet that would have provided worldwide air transportation for the Vice President, cabinet members, congressional delegations, Presidential emissaries and other high ranking dignitaries of the United States. The large VCX (C-32A) was a Boeing 757-200 passenger jet. The large VCX aircraft was to have been acquired under a lease with option to purchase contract.

- obtain Citicorp views on statutory and regulatory obstacles that prevent the use of commercial lease finance techniques in order to permit DoD to finance capital asset acquisitions and the sale-leaseback of DoD real property.

Mr. Schneider's memorandum stated that:

> Two potential capital asset lease concepts were discussed: (1) C-17 strategic airlift aircraft, and (2) a replacement aerial tanker for the existing fleet of – 500 KC-135 aircraft. The opportunity cost of tying up appropriated funds for decades on long-lived capital assets is an important incentive for the use of lease finance in the private sector. In view of the likelihood of tight topline budget constraints, preserving scarce Budget Authority for transformation and recovery of the capability of currently deployed forces is a high priority. The use of lease financing can contribute to these ends without a requirement for additional Budget Authority.

Mr. Schneider also stated that a Senator has a "strong interest in facilitating the use of such financing." A congressional staffer affirmed the Senator's intense interest in increasing the role of commercial financing in defense acquisition.

Subsequently, the Secretary of Defense asked Dr. Dov Zakheim, Under Secretary of Defense (Comptroller) on May 11, 2001, to initiate a process to get commercial financing techniques moving and to coordinate with the appropriate people, including the DoD Office of General Counsel.

September 2001. Ms. Druyun stated that the Air Force was leasing rather than purchasing the aircraft because funds were not in the budget to purchase tanker aircraft and that a lease deal was favorable to both a Senator and General John Jumper, Air Force Chief of Staff. Ms. Druyun was not sure who initially drafted the Department of Defense Appropriations Act for FY 2002 language; however, she stated that she, along with her staff, reviewed the language and might have made changes. Ms. Druyun also stated that Dr. James G. Roche, Secretary of the Air Force made the decision to use Federal Acquisition Regulation, Part 12 instead of Federal Acquisition Regulation, Part 15. In addition, Ms. Druyun stated that a Representative frequently called her requesting information about the tanker negotiations with Boeing.

On September 25, 2001, Ms. Druyun wanted to lease tanker aircraft that was also a "vision item" of Dr. Roche's. Boeing, a Senator, and the Air Force could work Capital Hill and the Office of Management and Budget on the tanker aircraft lease. Specifically, notes from a Boeing meeting on September 25, 2001, attended by Ms. Druyun and Messrs. Daniels, Albaugh, Davis, Hill, Gillis, Gower, and Lindberg stated that:

- Ms. Druyun stated belief that Boeing was facing problems before September 11, 2001, and they need to share overhead impacts with DoD.
- Ms. Druyun had spoken with a Representative to purchase Boeing 767A tanker aircraft.

- Ms. Druyun wanted to lease tankers and this was a Secretary Roche vision item.
- Senate and House Appropriations Committees interested in increased capability.
- Major General Paul W. Essex, Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition) stated that the tanker need was 500 to 600 aircraft.
- Ms. Druyun wanted to take charts to Capital Hill on concept.
- Boeing, a Senator, and the Air Force could work Capital Hill and the Office of Management and Budget on concept.
- Major General Paul W. Essex suggested converting 136 KC-135E tanker aircraft to 100 Boeing 767A tanker aircraft.
- As a result of the meeting, Mr. John Sams at Boeing was tasked to develop briefs on the tanker aircraft lease concept by September 26, 2001, for Mr. Daniels and Ms. Druyun to take to Capital Hill.

On September 30, 2001, Boeing helped Ms. Druyun with a briefing for a Senator on leasing that illustrated the need to waive legal impediments and provide relief under Office of Management and Budget Circular No. A-11. Specifically, on September 30, 2001, in a "Boeing Update on USAF [U.S. Air Force] Tanker Campaign," Mr. John Sams at Boeing stated that the primary effort has focused on a briefing that Ms. Druyun expected to take to a Senator. Throughout the uniformed Air Force, the realization existed that leasing was considerably more costly to the Air Force and the taxpayer. To counter that position, the Air Force briefing would focus on leasing options and use numbers provided by Boeing. The slides would graphically illustrate the need to waive legal impediments and provide relief under A-11, "Preparation, Submission, and Execution of the Budget (2003)."

October 2001. The Air Force did not plan to fund the Boeing KC-767A Tanker Program out of its budget. [redacted] Air Force Air Mobility Command, stated that the Air Force was not going to take the Boeing KC-767A Tanker Program out of hide and that because the Air Force was not going to get the money any other way, it would have to do something else.

The original lease language that Boeing was working did not provide for leasing custom built aircraft. [redacted] Office of the Air Force Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition) stated that, with regards to the Department of Defense Appropriations Act for FY 2002 language, the Air Force provided input to the appropriations and authorizing committees. He recalled that one Air Force input was to go with an operating lease. In addition, [redacted] stated that the draft language was provided to Boeing, who edited it and provided their input to the language. The Air Force's first draft was made available to Boeing in October 2001. Because the Office of Management and Budget rules did not allow for leasing a custom built aircraft, the Air Force b(6)

determined that it would lease "green aircraft" (basic Boeing 767 aircraft) from a Special Purpose Entity and modify the aircraft into tankers.

On October 7, 2001, Ms. Druyun prepared a letter for Dr. Roche to send to a Representative on the need to "jump-starting" a replacement program for the KC-135 tanker aircraft fleet. Specifically, on October 7, 2001, Ms. Druyun prepared a draft letter to a Representative concerning the "jump-starting" of a replacement program for the KC-135 tanker aircraft fleet. She forwarded the draft to Major General Paul W. Essex, Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition). On October 9, 2001, at the direction of Major General Essex, the draft was forwarded to the Office of the Secretary of the Air Force. On October 9, 2001, Dr. Roche sent a letter to the Representative, which was basically the same as the draft prepared by Ms. Druyun.

On October 12, 2001, the Senate Appropriations Committee proposed a lease of a large number of tanker aircraft and tried to get scoring rules changed; however, the Congressional Budget Office and the Office of Management and Budget did not agree. Specifically, on October 12, 2001, Mr. Gerald Daniels at Boeing met with Dr. Roche and Ms. Druyun at which the following was discussed:

- The House Appropriations Committee has marked and probably included the PURCHASE of a small number of tankers.
- The Senate Appropriations Committee will mark next week with a LEASE of a larger number of tankers.
- The Senate Appropriations Committee is trying to get the scoring rules changed, but the Congressional Budget Office and the Office of Management and Budget are not buying it.
- Conference committee will either go to the House Appropriations Committee solution or to the Senate Appropriations Committee plan with an operating lease instead of capital lease for 100 tankers.
- The Air Force wants Boeing to support language for an operating lease.
- Ms. Druyun will make the actual contract favorable and is willing to go to the financial markets with Boeing to stress the low risk involved with a lease since the Air Force needs the tankers so badly.

November 2001. Lieutenant General Reynolds, Commander, Aeronautical Systems Center, Wright-Patterson Air Force Base chartered a "tiger" team to work a contract to lease KC-767 air refueling aircraft. The charter was to develop an implementation plan to lease aircraft.

On November 1, 2001, Mr. Edward C. "Pete" Aldridge, Jr., Under Secretary of Defense for Acquisition, Technology, and Logistics and Dr. Dov Zakheim, Under Secretary of Defense (Comptroller) issued a memorandum, stating that leasing had potential benefits and greater flexibility and that the Department should use multiyear leases as a means of acquiring capital

assets where it makes good business sense. Specifically, on November 1, Mr. Aldridge and Dr. Zakheim issued a memorandum, "Multiyear Leasing of Capital Assets," to the Secretaries of the Military Departments; the Commander in Chief, Special Operations Command; and the Directors of the Defense Agencies. In the memorandum, the Under Secretaries stated that "Leasing has several potential benefits to the Department and provides greater flexibility in dealing with changing requirements. The Department needs to use multiyear leases as a means of acquiring capital assets where it makes good business sense." Further, the Under Secretaries stated that they were jointly establishing a Leasing Review Panel and requested that the addressees identify candidate programs for acquisition by means of multiyear leases. The Under Secretaries also stated that the Panel would review all lease proposals projected to cost a total of $250 million or more over the life of the lease. After review of the proposals, the Panel would make recommendations to the Defense Acquisition Board or the DoD Chief Information Officer.

On November 8, 2001, the Congressional Budget Office explained that the only way to make the tanker aircraft program happen was to score it as a capital lease. Specifically, on November 8, 2001, according to Mr. John Sams at Boeing, Major General Essex, Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition) met with representatives from the Congressional Budget Office to receive an out-brief of the Office's recommended scoring position on the tanker lease program, which was as a capital lease. (Mr. Sams noted that Major General Essex's meeting with the Congressional Budget Office had the same "flavor" as did Boeing's meeting.) Further, Mr. Sams stated that, upon arriving, it was clear that the Congressional Budget Office's intent was to question Major General Essex about the details of the tanker lease program. Specifically:

> CBO [Congressional Budget Office] had decided that the program could only be scored as a Capital Lease (Lease-to-Own). Most of their questions were intended to have the Air Force provide statements to bolster their position.
>
> - CBO asked if AF [Air Force] will have a requirement for Tankers at the end of the lease. Gen [Major General] Essex responded they would, but the 767 might not necessarily be the Tanker for the future – that the AF will have an Analysis of Alternatives in the FEY [sic] budget to look at Tanker recapitalization.
> - CBO asked about the type of modifications necessary to convert a 767 to a tanker. Gen Essex explained that Cargo door & Cargo floor mods [modifications] would convert the a/c [aircraft] to a Cargo aircraft (with commercial value) and the boom, and hose & drogue would have to be added to make it a tanker.
> - CBO asked, then was it AF intent to turn these back over to Boeing at the end of the lease. Gen Essex explained [that] the AF wanted flexibility through this pilot program to either end the lease, extend the lease, or purchase the aircraft at some point.
> - CBO asked if Boeing has estimated the de-modification costs for these aircraft? [T]ermination liability required? [C]ost to finance? Gen Essex explained these questions could best be answered by Boeing. CBO asked the AF to get Boeing to provide this information.

Bottom Line: CBO concluded saying they could not find any other way to make this lease program happen except [by] scoring this as a Capital Lease. They are recommending to the Committees, as they did in our [Boeing's] meeting, that these aircraft could be procured using Advance Appropriations.

Mr. Sams also stated that Major General Essex thanked Boeing representatives for the pre-brief before the Air Force's meeting with the Congressional Budget Office. As a result, they were better prepared for the meeting.

December 2001. [redacted] Office of the Assistant Secretary of the Air Force (Financial Management and Comptroller) stated that [redacted] Office of the Air Force Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition) asked him to make certain assumptions that he though were a little unreasonable to make the lease look good. Further, he stated that [redacted] was basically delegated to run the show and his main function was to get the tanker aircraft operating lease on the ramps. From December 2001 to November 2002, [redacted] was a senior financial management economist assigned to review the Boeing KC-767A Tanker Program. [redacted] stated that he worked with other financial management people at Wright-Patterson Air Force Base: [redacted] and [redacted] In addition, he stated that [redacted] was basically delegated to run the show. [redacted] stated that, while he did not work with Major General Essex on a day-to-day basis, he worked the most with [redacted] and [redacted] Office of the Air Force Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition). Further, he stated that, while his main concern was looking at the numbers, the main function of [redacted] was to get something on the ramps. In regard to the lease, [redacted] asked him to make certain assumptions that he thought were a little unreasonable to make the lease look more attractive. There were a number of things in the analysis where he thought assumptions were not really valid. [redacted] stated that he sent a number of e-mails questioning certain assumptions and their defensibility. [redacted] was the main face to DoD and outside organizations and not the financial management side of the house. In addition, he stated that numbers were contorted a lot of different ways to sell the program.

[redacted] Office of the Assistant Secretary of the Air Force (Financial Management and Comptroller) remembered receiving a call from [redacted] Office of the Air Force Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition) asking if he was trying to torpedo the Air Force. In addition, [redacted] remembered Mr. Michael Montelongo, Assistant Secretary of the Air Force (Financial Management and Comptroller) coming to his office and saying "Hey, guys, we fought our fight, and, you know, this is the Air Force position. You know, it's time to get in line." He believed that Dr. Sambur knew the financial management position. [redacted] thought that financial management as an organization was fairly weak and did not think that Mr. Montelongo, as a personality, was as strong as Dr. Sambur. Further, [redacted] knew of an anonymous b(6)

e-mail to [redacted] stating that [redacted] had no integrity, et cetera, et cetera, a rather harsh and damning e-mail.

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On December 3, 2001, Ms. Druyun recognized that the Congressional Budget Office position on scoring the lease as a capital lease was a problem and stated that the Senate Appropriation Committee and Boeing were working the issue. Specifically, on December 3, 2001, Ms. Druyun spoke to Mr. Andrew Ellis at Boeing about the Congressional Budget Office tanker aircraft language. She expressed her view that the Congressional Budget Office construct was not viable. Subsequently, Ms. Druyun spoke to the Senate Appropriations Committee staff. After speaking with the Senate Appropriations Committee staff, Ms. Druyun called Mr. Ellis back to report. She stated that she was frustrated with the Congressional Budget Office and that knew that the Senate Appropriations Committee and Boeing were trying to work the issue.

On December 5, 2001, Ms. Druyun notified a Representative and a congressional staffer that the language on leasing tankers was not executable. The language required the lease of "green aircraft" (basic Boeing 767 aircraft) and then modification through a separate appropriation. She wanted the congressional language to describe the lease for a "commercial aircraft tanker" versus a green 767 aircraft because the Air Force did not have the money for the modification and would not meet the 90 percent fair market value rule. (In July 2003, the Office of Management and Budget changed the Office of Management and Budget Circular No. A-11 criteria to require Government unique features or enhancement to be financed up front and separate from the lease.) On December 5, 2001, Ms. Druyun sent this information in an e–mail to Dr. Roche; General John P. Jumper, Air Force Chief of Staff; General Robert H. Foglesong, Air Force Vice Chief of Staff; and Dr. Sambur. In the e-mail, Ms. Druyun stated that:

> [A Representative] and [a congressional staffer] faxed me the new language on leasing last night that will go to conference. They have fixed some of the issues but as written it is still not executable. [The Representative] called me again this AM to get my sense of its executability and this is what I said to him:
>
> - the language requires the AF [Air Force] [to] lease green 767 aircraft but procure thru separate Auth/Approp [Authorization/Appropriation] the mod to make it a tanker. This means the aircraft cost is [redacted] which I then do my fair market value 90% assessment. For a ten year lease I bust the 90% figure...its approx 116% under OMB [Office of Management and Budget] Circular A-11.
> - I asked if they could describe the lease for a "commercial aircraft tanker" vs [versus] green 767 a/c. My reasoning for this is that I believe Boeing can market a commercial 767 tanker which hopefully can include a boom and comm [communications] equipment for US and FMS [Foreign Military Sales] sales. This would not require the USAF [U.S. Air Force] to come up with [redacted] a copy for each a/c [aircraft] which I told him would probably be impossible to do with our current top line. Writing a lease for a commercial tanker largely solves this problem. Also it puts the value I would do an OMB Circular A-11 calculation on close to [redacted] and if I do it on two 5 year leases I believe I can come within the 90% rule since each is a stand alone calculation. SAF/IA [Air Force Deputy Under Secretary (International Affairs)] is looking at whether Boeing can have as a

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description in their commercial tanker some variation or options such as radios and have two commercial tanker offerings: US and FMS and non FMS subject to ITAR [International Traffic in Arms Regulations]. I should hear back on that later today.

- [The Representative] asked that I call [a congressional staffer] and discuss the changes that I would want to see happen in Conference. I am awaiting his call sometime today. [The Representative] and [the congressional staffer] told me that the prohibition to eventually buying these aircraft would be changed in the next couple of years. Apparently they have some backroom agreement on this. The lease would then be allowed to be scored annually per discussions they have had with CBO [Congressional Budget Office] and OMB if I can meet the A-11 requirements.

I will keep you posted. Boeing by next week can have a commercial tanker ready for marketing with a boom if I get a green light from IA [Air Force Deputy Under Secretary (International Affairs)] on my questions.

On December 5, 2001, Dr. Sambur touted that Ms. Druyun was doing an excellent job on Capital Hill to modify language on the tanker aircraft lease and that it was "approaching the doable range." Specifically, on December 5, 2001, in response to Ms. Druyun's December 5, 2001, e-mail, Dr. Sambur sent an e-mail to Dr. Roche, Ms. Druyun, General Jumper, and General Foglesong with a cc: to Mr. Willard H. Mitchell, Deputy Under Secretary of the Air Force (International Affairs) in which he stated that, "Since this email, Darleen [Druyun] has done an excellent job on the Hill to modify the language so that it [is] approaching the doable range."

On December 12, 2001, an Office of Management and Budget official sent a letter to a Representative expressing grave reservations about leasing tanker aircraft as part of an economic stimulus package. Specifically, on December 12, 2001, an Office of Management and Budget official sent a letter to a Representative in which he stated that "Thank you for your letter to [a White House official] requesting that the Administration's economic stimulus package include funding for the purchase or lease of Boeing 767 aircraft as the Air Force's next generation tanker. The [White House official] has asked me to respond on his behalf." Further, the Office of Management and Budget official discussed the Representative's concern about the economic well-being of the Boeing Company and stated that:

> In your letter you ask that the economic stimulus package include money for the lease or purchase of new B-767 aircraft as tankers for the Air Force. We have grave reservations about leasing these aircraft. Our analysis shows that over the long-term a lease-purchase program would be much more expensive than direct purchase of the same aircraft. With regard to the possibility of procuring the aircraft, we have now begun the programmatic and budget reviews necessary for the preparation for the FY 2003 Budget submission. In this process programs are evaluated in terms of their cost and potential military benefit. Please be assured that we will consider your request carefully as we prepare the FY 2003 Budget request.

On December 13, 2001, Boeing representatives, Dr. Sambur, Ms. Druyun, and financial analysts looked for solutions to meet lease criteria. On that date,

Mr. Gerald E. Daniels at Boeing sent an e-mail to Mr. Harry C. Stonecipher, Mr. Rudy F. De Leon, Mr. James F. Palmer, Mr. Michael M. Sears at Boeing with a cc: to Mr. Randall R. Simons, Mr. Bob Gower, and Mr. Andrew K. Ellis at Boeing in which he stated that:

> Continued dialogue today with Darleen [Druyun] and her new boss, Marv [Marvin] Sambur [Assistant Secretary of the Air Force (Acquisition)]. Randy Simons and Bob Gower [Boeing] will meet tomorrow morning with Darleen [Druyun] and her financial analysts to look at a family of solutions that meet these criteria: affordable to the Air Force, acceptable/realistic interest rates, acceptable residual value at the end of the lease, and reasonable lease term. In other words, this may come down to fewer aircraft and/or shorter lease periods if we have to fit it to the Air Force O&M [operation and maintenance] budget and meet all the laws that govern it. Air Force wants to do this deal. May end up with 15-17 aircraft for 7 years to meet all the constraints, but we're going to give it our best.

On December 17, 2001, Major General Paul W. Essex e-mailed Dr. Sambur that Ms. Druyun, Boeing, and Air Staff representatives had developed options that met the requirements for an operating lease. On that date, Major General Paul W. Essex, Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition) sent an e–mail to Dr. Sambur; Ms. Druyun; Lieutenant General Stephen Plummer, Air Force Principal Deputy (Acquisition); Mr. Blaise J. Durante, Air Force Deputy Assistant Secretary (Management Policy and Program Integration); [redacted] Office of the Air Force Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition); [redacted] Office of the Air Force Director of Global Reach Programs; [redacted] Office of the Air Force Director of Global Reach Programs; and [redacted] Chief, Mobility Division, Office of the Air Force Director of Global Reach Programs. In the e-mail, Major General Essex stated: b(6) - OSD Redaction

> Dr. Sambur
>
> Summary of actions taken:
>
> Mrs. Druyun, Boeing, and Air Staff reps met end of last week to develop and examine set of options which meet the requirements for an operating lease. Over weekend further refined these options and began building briefing which lays out an Integrated Master Schedule combining all Boeing and Government actions required to obtain congressional approval and initiate the program. We will brief this to Mrs. Druyun Wednesday at 0700, along with the matrix of options which meet the operating lease gates. The variables in the matrix are: purchase price, lease term, interest rate, residual value, and lease payment. All the options presented will meet the OMB [Office of Management and Budget] gates.
>
> I recommend that we brief Dr. Roche on Wednesday after this meeting, at which time we can also show him what he just asked for...how we got the old numbers and what are 'the real numbers.' I think it is important to remember that the old numbers were generated on a 'pilot program' which was really a capital lease by another name. That is off the table and we need to distance ourselves from them if we can.
>
> Mrs. Druyun and Gen [General] Plummer,

> This is what I sent to Dr. Sambur, at his request. He is going to call or e-mail SECAF [Secretary of the Air Force] about 767 numbers problem. As you can see, I am recommending we try to get SECAF to wait til[l] Wednesday to discuss the lease numbers. The previous lease numbers were for a pilot program which is completely different from what we're working toward now.

On December 18, 2001, Mr. Paul D. Wolfowitz, Deputy Secretary of Defense wanted a briefing paper on Boeing 767 leasing issues, including why the decision was made to lease versus buy, costs, scoring issues, and advantages and disadvantages. Specifically, on December 18, 2001, Mr. Jaymie Durnan, The Special Assistant to the Secretary and the Deputy Secretary of Defense sent an e-mail to Dr. Roche with a cc: to Mr. Aldridge; Brigadier General Batiste, Senior Military Assistant to the Deputy Secretary of Defense; and [redacted] In the e-mail, Mr. Durnan stated:

b(6) - OSD Redaction

> Jim,
>
> DSD [Deputy Secretary of Defense] asks that you provide him with a briefing paper on the 767 leasing issues. He would like the paper to include how the decision was made, why the decision was made to lease versus buy, the costs involved, the scoring issues involved, the advantages and disadvantages of leasing versus buying, were there alternatives to the 767 and what were they, and other relevant issues you deem appropriate. It would be helpful to give him a scorecard of why [a Senator], et al. are so opposed to it.
>
> He asks if you can providc the paper by cob [close-of-business] today and, if necessary, would like to schedule a meeting with Pete [Aldridge] Dov [Zakheim] and you tomorrow to discuss the issue.

On December 25, 2001, Dr. Roche, Dr. Sambur, and most senior Air Force officials discussed whether the Air Force could live with the tanker aircraft lease language in the law. Specifically, on December 25, 2001, [redacted] stated that Dr. Roche called together people from the Offices of the Air Force General Counsel, the Assistant Secretary of the Air Force (Financial Management and Comptroller), the Deputy Assistant Secretary of the Air Force for Contracting, and the Deputy Chief of Staff for Air and Space Operations to analyze the tanker aircraft lease language in the law, to determine what they understood Boeing's process to be, and to determine whether they could go forward with the Air Force budget. [redacted] recalled that they met over Christmas and everyone agreed it would be difficult. Almost all "two-letter" directorates at the Air Force Staff agreed to go forward. It was then that Dr. Sambur tasked [redacted] System Program Director, KC-767 System Program Office to press forward.

January 2002. The Air Force Integrated Process Team looked into the feasibility of leasing the aircraft called for in the congressional language. The Air Force Integrated Process Team was formed to look into the feasibility of leasing tanker aircraft as mentioned in Section 159 of the Department of Defense Appropriations Act for FY 2002. Team members were: [redacted] Cost Analyst; [redacted] Integrated Process Team lead, who was later replaced by [redacted] System Program Director for the KC-767 System Program Office; [redacted] Program Manager; [redacted] b(6)

contracts; [redacted] configuration; [redacted] former contracting officer, and others.

The KC-767 System Program Office was tasked to get on contract the lease called for in the congressional language. [redacted] Deputy Chief of Contracting, Air Force Materiel Command recalled attending a meeting directing the Aeronautical Systems Command, Wright-Patterson Air Force Base to get on contract the tanker aircraft lease called for in Section 8159 of the Department of Defense Appropriations Act for FY 2002. He stated that Lieutenant General Reynolds, Commander, Aeronautical Systems Command directed that the KC-767 System Program Office be set-up.

The Air Force contracting officer stated that he was marching to the congressional language to lease tanker aircraft. [redacted] Contracting Officer, Aeronautical Systems Command, Wright-Patterson Air Force Base stated that he was involved on the initial team that started work on the Commercial Derivative Air Refueling Aircraft, later changed to the KC-767 System Program Office. He stated that the Aeronautical Systems Command received short notice to get on contract the lease called for in Section 8159 of the Department of Defense Appropriations Act for FY 2002. In addition, Mr. Back stated that Lieutenant General Reynolds, Commander, Aeronautical Systems Command directed that the KC-767 System Program Office be set up to handle the tanker lease program. He further stated that Lieutenant General Reynolds may have received this direction from Headquarters, Air Force.

The Air Force Deputy Chief of Contracting stated that the KC-767 System Program Office was on the ragged edge trying to make the tanker aircraft operating lease fit. [redacted] stated that, in regard to the lease, "we pushed the edge of the envelope. There's no question that there were a couple of issues with regard to the operating lease [for the Boeing KC-767A tanker aircraft]. It was on the ragged edge. There's no question that it was on the edge and that we were really reaching to try and make it [the operating lease] fit."

February 2002. The KC-767 System Program Office at the Aeronautical Systems Command, Wright-Patterson Air Force Base was formed to support the Office of the Assistant Secretary of the Air Force (Acquisition). [redacted] Deputy Director, KC-767 System Program Office stated that the KC-767 System Program Office team was formed to support the Office of the Assistant Secretary of the Air Force (Acquisition).

Lieutenant General Reynolds, Commander, Aeronautical Systems Command assigned [redacted] to the KC-767 System Program Office team as the System Program Director to support the Office of the Assistant Secretary of the Air Force (Acquisition). At the time, [redacted] was working the KC-135 tanker aircraft replacement program. [redacted] stated that he reported to Brigadier General Ted F. Bowlds, Program Executive Officer for Strategic Programs, Office of the Assistant Secretary of the Air Force (Acquisition).

Brigadier General Ted F. Bowlds, Program Executive Officer for Strategic Programs, Office of the Assistant Secretary of the Air Force (Acquisition) stated that Ms. Druyun was running the program and that he was just an b(6)

action officer, not a decision maker. [redacted] Office of the Air Force Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition) was Ms. Druyun's inside person and Brigadier General Bowlds was concerned about what [redacted] was reporting back to Capital Hill. Brigadier General Bowlds stated that "she [Ms. Druyun] is very hands-on, and you were kind of like an action officer as opposed to a decision maker. You're just the implementer." Ms. Druyun would also pick a person to be her inside man or woman, that person was [redacted] In addition, Brigadier General Bowlds stated that, "So you basically, I got somebody out here running a program that is answerable not to me, not necessarily to his boss, Major General Essex at the time, and answers directly to [Ms.] Druyun." Brigadier General Bowlds further stated that:

> Because there was questions that were going back to the Hill, and it was, you know, two pages deep worth of the truth, but when it got to [redacted] it was, well, we can't tell that whole story, da da da da, we're only going to give them a paragraph and that's what we're going to send forward.

Brigadier General Bowlds stated that he mentioned to Major General Essex problems about being left out of a meeting. Specifically, at a meeting in Saint Louis, Missouri, Ms. Druyun pulled Brigadier General Bowlds; [redacted] System Program Director, KC-767 System Program Office; [redacted] and [redacted] Cost Price Analyst, Aeronautical Systems Command, Wright-Patterson Air Force Base aside and told the team that you are trying to drive the price too low and for [redacted] to work with the team to bring the price back up.

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On February 12, 2002, a Representative and a Senator worked on congressional language to help the Air Force achieve tanker recapitalization goals.

On February 20, 2002, Brigadier General Darryl A. Scott, Deputy Assistant Secretary (Contracting), Office of the Assistant Secretary of the Air Force (Acquisition) signed out a request for information to The Boeing Company and Airbus North America, Inc. (European Aeronautic Defence and Space Company, Incorporated) to begin the Air Force's market research and assess market capabilities in the area of commercial aerial tankers.

On February 26, 2002, a congressional staffer asked why an request for information was sent to Airbus North America, Inc. (European Aeronautic Defence and Space Company, Incorporated) when the Senate had already decided that Boeing would supply the tankers. Specifically, on February 26, 2002, a congressional staffer asked why the Air Force had asked Airbus to provide information in response to a request for information before notifying a Senator. The congressional staffer noted that the issue regarding Boeing supplying the tankers had been decided by an overwhelming vote of the Senate (98 to 2). In response, Brigadier General Darryl A. Scott explained that the request for information did not commit the Air Force to competition. The congressional staffer's final words were "It is important to pick and choose your friends very carefully. It is clear that you have chosen, and the Committee has noted it."

April 2002. [redacted], Cost Price Analyst, Aeronautical Systems Command, Wright-Patterson Air Force Base stated that the guidance from Ms. Druyun and Congress was to get an operating lease on contract, do it commercially, and get it from Boeing. [redacted] was involved in attempting to get the lease of 100 Boeing KC-767A tanker aircraft on contract. He stated that, basically, the team was formed to support the Office of the Assistant Secretary of the Air Force (Acquisition), which at the time was working the KC-135 replacement program. In addition, [redacted] stated that, around April 1, 2002, the team received instructions to start work with Boeing to finalize a contract. Specifically, he stated that the guidance from Ms. Druyun and Congress was to get an operating lease on contract, do it commercially, and get it from Boeing. [redacted] was told by Solomon Smith Barney that classic modeling of an operating lease would not work because of the lenders. Trying to do a reasonable residual value under the lease would not work because the lenders would not buy-in because of the loan to value ratio. When the Air Force turns the tanker aircraft back in, the marketplace would be saturated sometime after 20 planes were turned in and the last 30 or 40 planes may be sold as scrap. Further, [redacted] stated that, because the Air Force could not use any language stating that they intended to buy the Boeing KC-767A tanker aircraft, Dr. Roche and Ms. Druyun would offer "letters of comfort" when the time came. He also stated that [redacted], Office of the Air Force Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition) devised contract clause C102 to address the issue of residual value of only 10 percent after 6 years. The clause states that the planes have to be purchased at fair market value; however, if the fair market value is higher than the residual value, Boeing must give the Air Force a rebate. In addition, [redacted] stated that the Boeing and Air Force Integrated Product Team provided joint presentations and status reports to Ms. Druyun and Mr. Gerald E. Daniels at Boeing. After Ms. Druyun and Mr. Daniels retired, Brigadier General Bowlds and Mr. Jim Albaugh at Boeing received the briefings.

On April 8, 2002, at the DoD Press Briefing of Secretary Rumsfeld and General Richard B. Myers, Chairman, Joint Chiefs of Staff; General Myers stated that "Now, what we are talking about, leasing, this is an Air Force issue. The Air Force is looking at that, and they have not brought that to me, or to the Secretary."

On April 16, 2002, Senate Armed Services Committee professional staff informed Major General Essex; [redacted] Office of the Air Force Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition); and [redacted] Chief of Mobility and Special Operations Forces, Weapons Systems Liaison Division, Office of Air Force Legislative Liaison that leasing was perfectly acceptable if you get what you pay for. However, if you pay 90 percent of the assets value, you should obtain 90 percent of the assets life in return. A six-year lease for 90 percent of the cost of the aircraft is not a good deal. Those comments resulted from a discussion reported in an April 16, 2002, Tanker Lease Congressional Contact Report. Present at the discussion were four members of the Senate Armed Services Committee professional staff and three Air Force officials: Major General Essex, [redacted] and [redacted]

b(6) - OSD Redaction

On April 25, 2002, the Air Force did not answer questions from a reporter about whether the tanker aircraft lease purchase plan began when a Senator called the Air Force and requested that it use "creative funding" to buy Boeing KC-767A tanker aircraft. Specifically, on April 25, 2002, Mr. Julian E. Barnes, "U.S. News and World Report," submitted questions to Dr. Sambur. Question: I am told by two sources that the tanker lease purchase plan began when a Senator called the Air Force and requested that the service use "creative funding" to buy 767 tankers. I am further told the Senator said creative funding meant a lease. I understand it was this call that helped move the proposal to the top of the agenda. Is that true? When was the call? Who did the Senator speak with? Whose idea was the lease? Whose idea was it to buy 767s? Is the lease cost more than a purchase, will that limit the number of new tankers the Air Force can have long term? Answers were not provided to these questions.

May 2002. On May 3, in a letter to a Senator, the Office of Management and Budget stated that it interpreted the congressional language on the tanker aircraft to mean that the Air Force could lease basic aircraft and then modify the aircraft; however, the Air Force interpreted the language to mean that it could lease the converted aircraft because the aircraft qualified as "general purpose aircraft." The Air Force interpretation presumed that an active commercial market existed for the tanker aircraft. Specifically, on May 3, 2002, an Office of Management and Budget official sent a letter to a Senator in which he stated:

> Dear Senator:
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> Thank you for your letter of April 17, 2002 in which you asked us for the preliminary results of our analysis of the following areas related to the Air Force's tanker fleet.
>
> The Air Force's discussions with Boeing regarding leasing 100 B-767 tankers are still ongoing. We, therefore, have no basis to change our previous cost estimates for leasing or direct purchase of B-767 tanker aircraft. We believe, however, that there are four options for the tanker fleet:
>
> Do nothing. This is the path analyzed by the Air Force in its two studies. It results in increased long-term costs o[redacted] paid out over 40 years, accepts the risk of shortfalls in certain scenarios, but avoids potentially large up-front costs of $3-26 billion, depending on the option.
>
> Convert 126 KC-135'E' tanker models into KC-135'R' models. The AF [Air Force] has already conducted a re-engining and upgrade program for most of its KC-135s, to convert them to the 'R' model, which the Air Force plans to keep in service until perhaps 2030 or 2040 depending on usage. In all, the Air Force has already re-engined 410 aircraft, leaving only 126 'E' aircraft in the Air National Guard fleet with older engines that could also be converted into an 'R' model. Such an option could be achieved for an estimated cost of abou[redacted] spread over a period of 6 years (about [redacted]. The advantages of this option are that the fuel offload capacity of each aircraft would be increased and the total fleet capacity increased to solve some of the shortfalls identified in the TRS-05. Moreover, maintenance costs of the current aircraft would be reduced. In addition, this option would increase the capacity of the fleet sooner than other alternatives (all converted aircraft could be delivered by 2009).

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Direct purchase of 100 Boeing 767 tanker aircraft and retirement of the KC-135E fleet. Based on a price of [redacted] per airplane, which we understand is a reasonable possibility, and including required military construction, this option would cost approximately [redacted] and would not be complete before 2011/12. The Air Force would have to fully fund these aircraft in its budget request. New B-767s would provide the Air Force with all the advantages of a modern aircraft with greater availability and a potential life longer than that of converted KC-135R aircraft. However, because 100 B-767 aircraft would replace 126 KC-135Es, the total tanker fleet capacity would be reduced and would not solve any of the shortfalls identified in TRS-05.

Lease 100 Boeing 767 aircraft in accordance with section 8159 of the FY2002 Defense Appropriations Act. We understand section 8159 to mean that the lease would cover the aircraft in its basic, or transport, configuration, which the Air Force would then modify into a tanker configuration. At the end of the 10 year lease period the Air Force would de-modify the aircraft and return them to Boeing in their original transport configuration. In this way the Air Force could meet the criteria of an operating lease. The Air Force believes that the base aircraft cost is [redacted] with tanker conversion and de-conversion costs adding [redacted] to the price. As we indicated to you in our letter dated December 18, 2001, we believe that the total cost of this option would be [redacted] in then-year dollars. This option would provide aircraft on the same schedule and have the same tanking capacity as the direct purchase option with lower near-term costs, but would require that the Air Force return the aircraft after 10 years, meaning that they would have to develop an alternative for the tanker fleet by that time.

We have no basis at this time to change our [redacted] estimate, since b(5)
discussions between the Air Force and Boeing to determine the possible lease arrangements for such an aircraft are still ongoing. However, we understand that the Air Force interprets section 8159, together with a colloquy reported in the Congressional record on December 20, 2001, to mean that a B-767 tanker is a general purpose aircraft. In an exchange involving Senators, the Members stated they believed a converted 767 qualified 'as a general purpose aircraft.' This position presumes there is an active commercial market for tankers which would therefore relieve the Air Force of costs associated with conversions.

Clearly, this interpretation would make it financially easier for the Air Force to meet the conditions for an operating lease imposed by section 8159 because they could amortize the costs of tanker conversions over ten years instead of paying for conversions up front. While we are currently unaware of any commercial buyer or interest in purchasing 100 tankers, OMB will provide its views on the Air Force interpretation to you in the next few weeks.

Leasing policy

You asked us to examine the policy of leasing major defense programs and to evaluate the role of DoD's recently established Leasing Review Panel. When analyzing capital leases, we believe it is critically important to compare the full cost of the lease with other methods of acquiring the capital assets, including direct purchases. We also believe that [a White House official] and the Congress should consider the full cost of capital acquisitions when they make budget decisions to allocate resources to Federal agencies and programs. For that reason, we strongly support the budget scoring rules for leases, which were agreed to by the Congress and [the White House official] as part of the Budget Enforcement Act of 1990. The rules distinguish operating leases from capital leases and address the fact that some capital leases are virtually equivalent to the purchase of a capital asset, with most or all of the benefits and risks of

ownership transferred to the government, while others are more like rentals. They require agencies to fund the full cost of purchases, lease purchases, and capital leases up-front in the first year of the transaction. In this way, the full cost is recognized at the time when decisions are made to incur that cost, regardless of the source and form of financing, so that Congress and [the White House official] have the incentive and the information necessary to make the most efficient use of taxpayers' money.

The Defense Department's Leasing Review Panel, of which OMB is a member, has not yet met because the Air Force has not yet completed its proposal to lease B-767s and B-737 executive jets.

On May 7, 2002, the Congressional Budget Office expressed to a Senator its concerns about why leasing tankers will cost more than the direct purchase and estimated that, in net present value terms, the lease would cost about $4 billion more than the purchase option. Factors that make leasing tankers more costly included the additional cost of financing, risk associated with a limited market, increased administrative costs, and long-term requirement for assets. Specifically, on May 7, 2002, the Congressional Budget Office sent a letter to a Senator that addressed its analysis of the tanker lease. The Congressional Budget Office analysis showed:

Factors that tend to make the lease of such assets by the government more costly than a direct purchase include the lessor's cost of financing (which is higher than the cost of Treasury borrowing), the need to set lease payments high enough to compensate the lessor for the risk he incurs by producing an asset for which there is a limited market, and any increased administrative costs associated with a lease rather than an outright purchase. Further, in this case, the need for tanker capability will presumably not expire with the lease term – something must be purchased or leased to replace it. Therefore, we have included an estimate of the cost to purchase these tankers at the end of the lease term – the most likely option to preserve tanker capability.

Leases have a greater potential to be cost-effective if the government does not have a long-term requirement for the asset. That does not appear to be the case here. Cost-effective leases also require the existence of a substantial market (by scoring rules, a private market) into which to sell assets at the end of the lease. While there is no private market for tankers, even the public, government market is not likely to absorb more that a few of the 100 tankers.

The Congressional Budget Office estimated that the purchase option would cost about [redacted] in current dollars over the period from 2003 to 2020 and [redacted] in net present value while the lease option would cost about [redacted] over the same period and [redacted] in net present value. b(5)

On May 22, 2002, Boeing received guidance from Major General Essex to follow the advice from [redacted] Office of the Air Force Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition) and not from the KC-767 System Program Office. Boeing was trying to obfuscate construction financing, transaction costs, and lease administration costs into aircraft price. Boeing believed that emphasis was not on aircraft price but on making the business case close for the lease. b(6) Specifically, on May 22, 2002, a Boeing e-mail from Mr. John Ferguson to

Mr. Randall Simons with a cc: to Mr. John Sams about the Boeing KC-767A tanker aircraft lease stated that:

> John Sams apparently did talk with MGen [Major General] Essex. Advise was to follow [redacted] advise not SPO [KC-767 System Program Office]. Given your low opinion of [redacted] business acumen, that may be dangerous – so my advise to [redacted] and team is to be cautious and make sure the deal can stand the light of day. b(6)
>
> The team is still working the art of the possible in terms of obfuscating construction financing, transaction costs and lease administration by folding all three into aircraft price to help the business case close. [redacted] comments in that regard tend to support my thesis that they are not as concerned about aircraft price as we might have been led to believe. Emphasis at this point might best be shifted to making their business case close – regardless of our view of its validity. Big issue will be cash flow both from the stand point of rolling construction financing, etc. into price as well as team reported issue that "market" may not be willing to finance more than about 80% of "average price." If so, this will give us some front end issues.

On May 30, 2002, Boeing and [redacted] are trying to make the business case work. On that date, [redacted] sent an e-mail to [redacted] at Boeing and to [redacted] System Program Director, KC-767 System Program Office that provided news on the Boeing 767 Business Case Analysis. [redacted] stated that news from a meeting with the Office of Management and Budget was that Air Force would be allowed to build the purchase alternative funding profile for years in which funds would be expended. Specifically, commercial payment practices, such as 35 percent with order, 35 percent mid-payment, and 30 percent on delivery could be used. In an e-mail response from Mr. John Sams at Boeing: [redacted] b(6) - OSD Redaction b(4) - OSD Redaction

July 2002. On July 10, the Air Force was having problems with the business case analysis. On that date, [redacted] stated that a problem existed with the Boeing commercial airplane analysis. In addition, he stated that he had a question regarding the Boeing commercial airplane purchase price: b(6) - OSD Redaction

> Would we be allow 15% advance payment in the first year of a 100 a/c [aircraft] commercial buy, even though they're segregated into several lots, and would anyone actually give us the budget to do it? If unrealistic, we'll be roasted for manipulating the analysis, even if legal. A better approach would be that, given we would NOT do a 15% adv [advance] payment, the unit would go up – THAT's the price you put into the BCA [business case analysis] with a "normal" payment schedule. We can justify an adv payment on the lease, because we get a lower cost. Surely, the same can be said of a hypothetical purchase price.

August 2002. [redacted] Supervisory Cost Analyst, Aeronautical Systems Command, Wright-Patterson Air Force Base, expressed concerns about the operating lease, but his concerns only got as far as the KC-767 System Program Office. He stated that he had many concerns about the operating lease; however, [redacted] had received Air Force approval to go forward with the operating lease. He elevated his concerns to b(6)

Mr. Michael Montelongo, Assistant Secretary of the Air Force (Financial Management and Comptroller) and showed him that, when realistic assumptions were used, the tanker aircraft purchase alternative was at least $2.1 billion less than the lease alternative. After the issue was raised, Ms. Druyun called General Lyles, Commander, Air Force Materiel Command, and told him she no longer needed the financial management team at the Aeronautical Systems Command on the project.

In addition, [redacted] stated that under the guise of transformation, the normal acquisition process was not followed. Supposedly, [redacted] and company up to the Office of the Secretary of the Air Force (Acquisition) had received approval for the tanker aircraft lease to be an operating lease. [redacted] also stated that the goal was to get a contract at any cost and that the lease had lots of issues, such as how to determine fair market value. Further, he stated that his boss, [redacted] elevated the lease issues to Lieutenant General Reynolds, Commander, Aeronautical Systems Center, Wright-Patterson Air Force Base, who contacted General Lyles, Commander, Air Force Materiel Command, in July 2002, about the issues.

Further, [redacted] stated that in early August 2002, the Office of the Deputy Assistant Secretary of the Air Force (Cost and Economics) briefed Mr. Michael Montelongo, Assistant Secretary of the Air Force (Financial Management and Comptroller) on the Commercial Derivative Air Refueling Aircraft lease program. The brief concluded that, when realistic assumptions were used, the purchase alternative was at least $2.1 billion less than the lease alternative and recommended that that the business case analysis for the program should not be coordinated unless more realistic assumptions were used. The briefing showed that the Office of the Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition) would not use the most probable interest rates for business case analysis inputs to budget estimates and that finance interest rates in the business case analysis were unrealistic, too low, and not fixed. Further, [redacted] stated that, because of the issues being raised, Ms. Druyun basically fired [redacted] and her team by calling General Lyles and telling him that she no longer neede[redacted] and her team on the project. As a result of the firing, Brigadier General Bowlds requested that anyone, who had a problem with the tanker aircraft lease, should be in his office on Monday to discuss the problem. In the meantime, [redacted] got a call from Lieutenant General Reynolds who had gotten a call from General Lyles in which he stated that he wanted a group to go to Washington, DC the next week to present their concerns. b(6)
(See the following August 27, 2002, discussion.)

On August 1, 2002, an Office of Management and Budget official sent a letter to a Senator in which he stated that all current discussions between the Office of Management and Budget and the Air Force on the Boeing 767s indicate that it was unlikely that a proposal could be crafted that complied with the lease requirements. Further, the Office of Management and Budget official stated that Office of Management and Budget discussions with the Air Force suggest that the cost of an operational lease of Boeing 767s would substantially exceed the purchase price of Boeing 767s and that any reconfigured Boeing 767s as tanker aircraft would be designed for unique government purposes and would not be commercially viable. (Department of Defense Office of the

Inspector General Audit Report No. D-2004-064, "Acquisition of the Boeing KC-767A Tanker Aircraft," March 29, 2004, also reported that the Boeing KC-767A tanker aircraft lease did not meet Office of Management and Budget Circular No. A-11 criteria requiring that the asset be a general purpose asset and not be built for unique Government purposes.) The Office of Management and Budget official also stated that to support any lease proposal that would cost tax payers more than direct purchase would be inconsistent with Office of Management and Budget circulars and irresponsible.

On August 2, 2002, [redacted] sent an e-mail to Major General Essex in which he identified potential Office of Management and Budget problems with the Boeing KC-767A tanker aircraft lease. Specifically, he stated that an Office of Management and Budget official believed that:

- a 767 proposal that complies with Office of Management and Budget circulars and policy is unlikely;
- the cost of a lease will "substantially exceed" a purchase price;
- a tanker is a unique government asset (thus failing one of the tests for an operating lease); and
- termination liability must be funded or Office of Management and Budget will not consider a lease.

[redacted] suggested a plan to eliminate the Office of Management and Budget concerns. He suggested:

- maximum interaction with Office of Management and Budget personnel;
- let Office of Management and Budget Circular No. A-94 analysis stand on its own;
- agree on tanker market but suggested that aircraft will be sold as freighters; and
- termination liability is an already know problem.

In addition, [redacted] stated that Congress would need to provide legislative relief.

On August 2, 2002, Boeing would not agree on capping construction financing costs that would quickly break the Office of Management and Budget Circular No. A-94 business case model. Boeing stated that the Office of Management and Budget Circular No. A-94 business case analysis would most likely pass a test by the Office of Management and Budget; however, the analysis measures the illogical conclusion that to lease now is better than to buy now. Further, Boeing believed that it was not possible to state that the lease makes economic sense, just that the tanker deal passed the tests. b(6) - OSD Redaction
Specifically, on August 2, 2002, a Boeing e-mail from Mr. Walter Skowronski to Mr. Robert Gordon stated that:

> Pricing on construction financing finally dawned on USAF [U.S. Air Force]. Today's rates of Labor + 1% = 3% look great. But every change of 1% upwards will add [redacted] per plane which will quickly break the OMB [Office of Management and Budget] A-94 model. USAF asked Boeing to cap it. Answer: No. b(4)

Mr. Walter Skowronski also stated that:

> Briefly, the OMB [Office of Management and Budget] A-94 Business Case Analysis will most likely pass the test. But this test measures the illogical conclusion that it is better to lease now than to buy now. This won't make sense in the newspapers. Furthermore, neither Boeing nor SSMB would ever put its hand on a bible and say that makes economic sense. So, we need to take the high ground: the government has a variety of tests and analysis that are designed to control the procurement process. The tanker deal passes those tests.

On August 27, 2002, Brigadier General Ted F. Bowlds had [redacted] brief Ms. Druyun, Major General Paul W. Essex, [redacted] the Boeing team, and the [redacted] team on tanker program concerns, not just the operating lease. The briefing showed that the operating lease was about $1.658 billion more than purchasing the tanker aircraft. Ms. Druyun halted the briefing after about five charts were shown and stated that she did not want to see numbers like that again where leasing cost more than purchasing the tanker aircraft. Brigadier General Bowlds stated that he wanted [redacted] to attend an Office of Management and Budget meeting with [redacted] however, Ms. Druyun countermanded the suggestion. [redacted] stated that very few people in the briefing really knew the implications of the price, construction financing, the lease financing, and what the Air Force was actually going to pay at the end of the day. [redacted] also stated that the [redacted] representatives were sensitive to the Enron scandal and were up front, stating that, you know, the lease was going to cost more than the purchase. [redacted] stated that another problem with the lease was that a commercial market did not exist for the Boeing KC-767A tanker aircraft. In addition, he stated that, in another meeting, a Boeing Representative stated that maybe the whole process was being looked at incorrectly and that we should go back to stating that the lease would cost more than the purchase. However, Ms. Druyun and Major General Essex did not agree with that line of thought and shut it down real quick.

On August 27, 2002, in regard to a briefing on that date about the lease analysis, [redacted], Cost Price Analyst, Aeronautical Systems Command, Wright-Patterson Air Force Base stated that [redacted] got to about his second chart and Ms. Druyun basically "gunned him down." She told him to "sit down and shut up, basically." [redacted] didn't say boo to defend her person and "it was pretty intimidating." When [redacted] went down in "flames" the conversation turned to "well, what should we use."

On August 28, 2002, [redacted] sent an e-mail to Dr. Sambur, Ms. Druyun, Major General Essex, and Brigadier General Bowlds stating that the preliminary lease arrangement passed the Office of Management and Budget business case analysis by a slim margin and would save money compared to buying. Further, he stated:

b(6) - OSD Redaction

Sir,

Per your request:

Info we've made public:

Negotiations continue and are entering their final phase. We are cautiously optimistic that a lease deal that complies with the law and OMB [Office of Management and Budget] circulars can be reached. Once approved by SECAF [Secretary of the Air Force], we will present the business case to OMB and the OSD [Office of the Secretary of Defense] Leasing Panel, followed by a report to Congress. A lease contract will not be signed without approval from all four defense committees and appropriate funding.

Info not yet made public:

The preliminary lease arrangement passes the OMB business case analysis by a slim margin and will save money compared to buying. We are currently running sensitivity analyses to prepare for – and ensure the deal can stand up to – criticism similar to that seen with the 737 deal. We are actively engaging OMB to get their buy-in on the analysis -- a critical ally needed to defend the lease. I expect they will support the analysis, but will baulk at supporting our need to escape funding termination liability (peaks at [redacted] in FY07; will need Congressional language to overcome). OMB has also stated they believe a tanker is not a commercial product (a key test for an operating lease), but if the business case holds, I don't think OMB will make this issue a deal-killer.

b(4) - OSD Redaction

On August 28, 2002, Dr. Sambur asks [redacted] whether they should pulse the Senate Armed Services Committee on the termination liability issue. Specifically, on August 28, 2002, in response to [redacted] e-mail, Dr. Sambur sent an e-mail to [redacted] with a cc: to Ms. Druyun, Major General Essex, and Brigadier General Bowlds in which he stated:

b(6) - OSD Redaction

Thanks

I assume you resolved the residual value issue from this update?

Should we pulse the SASC [Senate Armed Services Committee] staffers on the termination liability issue?

On August 28, 2002, in response to Dr. Sambur's e-mail, [redacted] stated:

b(6) - OSD Redaction

Sir,

Residual value issue of rebating resale profit to the gov't is still in OMB's [Office of Management and Budget] hands. They've never seen anything like it before, and after 2 weeks of chewing on it, have not vetoed the concept. However, when I spoke with Rob Goldberg today, he cautioned me that 767 is so political that his input is only advice – [redacted]

b(5) - OSD Redaction

*Removed for reason stated in the initial asterisked footnote. (The reference is also on page 97.)

I defer to Mrs. Druyun on the question of talking to SASC [Senate Armed Services Committee] staffers.

September 2002. On September 11, Dr. Sambur sent an e-mail to Dr. Roche in which he stated that the economic justification for the tanker is not a slam dunk for either position (purchase or lease). Specifically, he stated:

> Boss
>
> I kicked off the effort to establish 'need' justification for the tankers. Hope to have conceptual frame ready by the end of the week.
>
> Spoke to Robin [Cleveland] after meeting to tell her that the economic justification is not a slam dunk for either position (purchase or lease). It is more a push and a slight change in the interest rates can flip the analysis. At the end of the day, we have to prove that there is a TRUE need and that there are other advantages to leasing (earlier deliver, affordability, etc) that make it a good business deal. It is going to be a tough sell given the other factors such as liability and indemnification.
>
> Marv

On September 20, 2002, Boeing reported that a Representative and another Representative spoke directly with a White House official about the tanker lease deal. Specifically, on September 20, 2002, Mr. Rudy F. De Leon at Boeing sent an e-mail to Mr. Jim Albaugh, Mr. Douglas G. Bain, Mr. James A. Bell, Mr. Scott E. Carson, Mr. Phillip M. Condit, Mr. Gerald E. Daniels, Mr. John B. Hayhurst, Mr. James C. Johnson, Mr. Paul Kinscherff, Ms. Laurette T. Koellner, Ms. Judith Muhlberg, Mr. Alan Mulally, Mr. James F. Palmer, Mr. Thomas R. Pickering, Mr. Michael M. Sears, Mr. Walter E. Skowronski, Ms. Bonnie W. Soodik, Mr. Harry C. Stonecipher, and Mr. David O. Swain at Boeing. In the e-mail, Mr. De Leon stated that:

> Activity Increasing on 767 Tanker Initiative
>
> [A Representative] and [another Representative] spoke directly with [a White House official] in support of moving ahead on the tanker lease. In both cases, [the White House official] reportedly expressed his support for moving ahead with the tanker initiative, and asked [another White House official] to be 'on point' for this effort. [A Representative] has followed up directly with [the other White House official]. [A Representative] also spoke directly with [the other White House official], with particular emphasis on the important distinction between leasing (now) versus buying (later). Secretary Roche, and [an Office of Management and Budget official], have both recently indicated that if the lease deal gets too complicated, then the Air Force would look to a traditional procurement (2-3 years later than lease with much slower acquisition ramp-up).
>
> [A] Senator continues to engage with OMB. [A Representative] engaged directly with OMB – of note from discussion was [an Office of Management and Budget official's] reference to nothing getting done prior to the November election. Secretary Roche has continued to discuss issue with [an Office of Management and Budget official], and [the Official] reportedly is arguing against the lease based primarily on concern over the size of the deal and the precedent it may set. OMB staff continue to manipulate variables and assumptions that decrease the attractiveness of the net present value business case analysis, and are also questioning the need to accelerate recapitalization of the tanker force based on existing Air Force analysis of the potential service life of the

KC-135 force. Boeing is working with Air Force to rebut OMB on this point. In a meeting with Jim Albaugh, Assistant Secretary of the Air Force, Marv Sambur, commented that Secretary Roche was on board. This is the most optimistic Secretary Sambur has been on the tanker deal this past year. Efforts to generate direct state, local and federal support for the tanker initiative are underway through contact with National Guard Adjutant Generals.

Jim Albaugh Visits with Member of Congress

This week, Jim Albaugh made a number of personal calls to Members of Congress in support of Boeing programs being resolved for the FY-03 defense bills. Reports on individual programs such as additional F/A-18's were very favorable. The 767 tanker lease program was a recurring topic on each call. Of significance, was the general universal support for the 767 tanker lease. Several senior members indicated their preference for a tanker procurement program instead of a lease but indicated their support for the lease if the numbers proved to be 'good deal.' Several members supporting the tanker initiative reported extremely positive comments from the Administration.

On September 23, 2002, a Senator wanted to know what the effect on the lease proposal was if the Air Force provisions on termination liability were not included in the bill. The provision allowed the Air Force to carry termination liability as a contingent liability and would not require the Air Force to set aside the liability amount. The lease deal became unaffordable if the termination liability bills must be specifically budgeted (peaks at [redacted] in FY 2007). On September 23, 2002, [redacted], Office of the Air Force Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition) sent an e-mail to Major General Essex and [redacted] in which he stated: b(4) - OSD Redaction

Sirs,

[redacted] (FML) relayed the following three questions from [a Senator]. Needs answers by 1100. Recommended answers provided. Recommend approval for release. b(6) - OSD Redaction

1) What is the effect on the lease proposal if the general provisions requested by the USAF [U.S. Air Force] are not included in the bill?

A1) The provisions will allow the USAF to carry termination liability as a contingent liability and will not require the service to set aside the liability amount. The lease deal becomes unaffordable if the termination liability bills must be specifically budgeted.

2) What is the annual bill for termination liability that must be budgeted for under OMB's [Office of Management and Budget] rules?

A2) Starting in FY03 the following is the termination liability per year in [redacted] b(4) - OSD Redaction

3) What is the schedule for going on contract and what is the leased aircraft delivery schedule?

A3) Boeing and USAF remain in negotiations. The negotiating team projects a December Contract award, if AF [Air Force], OSD [Office of the Secretary of Defense], OMB [Office of Management and Budget], and Congress concur with the negotiated lease. Based on a December 2002 contract award, the delivery schedule is: starting in FY06 11/16/20/20/20/13 (last delivery is FY11).

In October 2002, Mr. Richard P. Burke, Deputy Director for Resource Analysis, Office of Program Analysis and Evaluation stated that, in general, leasing a long-term asset was a dumb idea and that the tanker lease was clearly a lease/buy proposal. Further, he stated that Office of Management and Budget regulations prohibit lease/buy provisions when awarding contracts for operating leases. Mr. Burke also stated that the Air Force saw the lease as a way to keep the tanker off budget in the near term, and then, you know, it would be put on their budget in the long term. He did not believe that the appropriators took kindly to that kind of thing and that was the reason for Office of Management and Budget Circular No. A-11. Lease/buy provisions in contracts tend to lead to no requirement for funding up front and obligating the Government and future Congresses to things that are not apparent in the early start of the programs.

In addition, Mr. Burke stated that he and [redacted] Department of Defense Office of the General Counsel chaired a meeting between the Institute for Defense Analyses and Boeing on the analysis by the Institute for Defense Analyses. He further stated that the Boeing representatives were "sweating profusely during that entire meeting." Mr. Burke recalled a call from Dr. Sambur's office in which the caller wanted to know how much work the Air Force did with the Institute for Defense Analyses. He interpreted that question as a "thinly veiled threat" in that the Air Force was going to pull work and would strongly complain to his boss Mr. Kenneth J. Krieg, Director, Program Analysis and Evaluation. Mr. Burke also stated that "Leasing things long-term like this [tanker aircraft] is just a bad idea economically. You can go to any economics course and get taught this over and over again. There's no way you can meet the conditions the Department has on borrowing funds from the Treasury." Further, he stated that, from the start, the Office of Program Analysis and Evaluation questioned how can you [the Air Force] do this? How can you violate Office of Management and Budget Circular No. A-11, which was set up specifically to preclude this kind of transaction? Mr. Burke also did not know why the Office of Management and Budget did not declare this [a violation] earlier.

On October 1, 2002, an Office of Management and Budget representative told [redacted] that the Boeing KC-767A tanker lease could never pass the requirements of Office of Management and Budget Circular No. A-94, so if the KC-767 did pass today, he would change the rules until it could not pass. In an e-mail from [redacted] to Ms. Druyun with a cc: to Major General Essex, he stated that:

b(6) - OSD Redaction

> As expected, we only heard one real objection – our choice of discount rate. We did it the way the circular told us to do it, but as the [Office of Management and Budget Circular No.] A-94 author said in the meeting, he wrote it and he can always change it. He stated that OMB's [Office of Management and Budget's] philosophy is you can never pass A-94, so if KC-767 did pass today, he'd change the rules until we couldn't. He threw out several ideas on how he thought he might stop us (all of them arbitrary and capricious), thus providing free intel on how to counter (we'd already thought them through, but this confirmed our suspicions). An interesting fellow – I bet he's a terrible poker player.

On October 11, 2002, [redacted] Office of the Air Force Director of Global Reach Programs sent an e-mail to Major General Essex, [redacted], and [redacted], Chief, Mobility Division, Office of the Air Force Director of Global Reach Programs in which he stated that a Representative advised that the Air Force should meet critics of the tanker initiative head-on and elevate the discussion to the real decision makers: the Secretary of Defense and a [redacted] b(6) - OSD Redaction b(5) - OSD Redaction

On October 21, 2002, Dr. Sambur sent an e-mail to Dr. Roche in which he stated that he briefed Ms. Robin Cleveland, Office of Management and Budget, on why the proposal met the requirements for an operating lease. At the briefing, the Office of Management and Budget official was quite upset that Boeing representatives were there to answer questions. Dr. Sambur briefed Ms. Cleveland on the requirements justification, price of the "green aircraft" (basic Boeing 767 aircraft), why the proposal met the requirements of an operating lease, and the legal ramifications of a Special Purpose Entity.

[redacted] b(5) - OSD Redaction

On October 23, 2002, [redacted] sent a e-mail to [redacted], Air Force Strategic Programs, Office of the Assistant Secretary of the Air Force (Acquisition) in which he stated that, based on different discount rates (15-year and 6-year), the net present value analysis favored lease by [redacted] using a 15-year rate at 5.275 percent and favored purchase by [redacted] using a 6-year rate at 4.65 percent. b(6) - OSD Redaction b(4) - OSD Redaction

On October 28, 2002, Dr. Roche and members of the Office of the Assistant Secretary of the Air Force (Acquisition) briefed a [redacted] b(5) - OSD Redaction

On October 29, 2002, Mr. John B. Sams, Jr. at Boeing stated in an e-mail that a White House official met with Dr. Roche and representatives from the Offices of Management and Budget and the Secretary of Defense and that the meeting was characterized as "a draw." Mr. Sams stated that the White House official focus was on whether a sense of urgency relating to the aviation industry existed, on whether interest rates supported acting now, and on how many jobs the tanker aircraft lease would create.

On October 29, 2002, Mr. Andrew Ellis at Boeing sent an e-mail to Ms. Druyun in which he stated that the number of jobs and the value of those jobs associated with the tanker aircraft lease was about [redacted] direct jobs by [redacted]. b(4)

November 2002. On November 12, [redacted] Office of the Air Force Director of Global Reach Programs sent a copy of the November 7, 2002, KC-135 Tanker Modernization Action Group "Questions b(6) - OSD Redaction

*Removed for reason stated in the initial asterisked footnote.

and Answers" to senior Air Force officials on why the Air Force was leasing Boeing KC-767A tanker aircraft rather than buying them. The questions and answers relating to the lease proposal are:

> Q5. Why does the Air Force want to lease 767 tankers rather than buy them? Why the Urgency?
>
> A5. Soundbite. Leasing fills a combat need for the USAF [U.S. Air Force] and takes advantage of the current low interest rates, slow economic conditions, and creates jobs throughout the country.
>
> A.5. The Air Force does not have enough money to buy new tankers today. Leasing is the only affordable solution at this time. Leasing requires less money upfront and allows the Air Force to spread the acquisition cost over the life of the lease. That means the Air Force can begin replacing the KC-135E three years earlier than if they had to wait until they could afford to buy the 767. Waiting to begin replacement will result in higher unit costs and a slower "ramp-up" of much needed new aircraft.

On November 20, 2002, Major General Essex sent an e-mail to Air Force senior staff in which he responded to discussions about postponing the Boeing KC-767A tanker aircraft lease and provided information on the consequences of that choice. He stated:

> Sirs
>
> I understand that within the Air Force senior staff, there is now serious discussion about postponing the 767 lease program. I am therefore providing some information on the consequences of that choice.
>
> The impact of waiting to execute the lease program until 2005 could be substantial in terms of both cost and schedule. Specifically,
>
> The current economic conditions of low interest rates and depressed aircraft prices are predicted to turn around by the end of 2005. This will seriously degrade the negotiation leverage we've taken advantage of today.
>
> If the 2005 negotiation results in a real price increase of just 5%, we will have to drop one aircraft per year to live within our budget. This will add further cost and stretch-out the KC-135 recapitalization effort two more years in addition to the two-year late start.
>
> A 5 percent price increase due to loss of negotiation leverage will add more than $700M [million] to the cost of the first 100 KC-767s.
>
> A delay of 2 years could kill the lease by cutting in half the "jump-start" advantage over the POM [Program Objectives Memorandum] buy profile (some may see this as a good thing!). In addition, the momentum we've built today to gain lease approval will be lost, including, perhaps, Congressional support.
>
> Also, it should be noted that the political heat from several congressional members will be significant and retaliations will likely be threatened. Couple this with the fact that the SecAF [Secretary of the Air Force] has spent a tremendous amount of political capital on the need to do this deal now, and I urge caution in suggesting the AF [Air Force] back away from this deal. (and the answer to the obvious question is . . . no, I still don't know how to pay for this)

On November 22, 2002, Boeing officials commented that Dr. Roche had assumed the lead advocate role within the Office of the Secretary of Defense

to push the lease. Specifically, Mr. John B. Sams, Jr. at Boeing sent an e-mail to Mr. Bob Gower at Boeing with a cc: to Mr. Jack M. House, Mr. Jerry D. Rejko; Mr. Darrell A. West, Mr. Richard C. Robinson, Mr. Steven R. Karrasch, and Mr. Thomas A. Owens at Boeing in which he stated:

> For Boeing Only
>
> Had a meeting with Gen [General] Essex and [redacted] b(6)
> today in DC [District of Columbia], with an excellent exchange covering where we are in process, and path forward.
>
> From an overall process, the breakout position for the players is as follows:
>
> - AF [Air Force] -Sec [Secretary] Roche has assumed lead advocate role with OSD [Office of the Secretary of Defense] to push the lease. Personal correspondence to Pete Aldridge [Under Secretary of Defense for Acquisition, Technology, and Logistics] clearly establishes the AF desire for the lease, and pushes back against OSD 'bureaucrats' who are resisting change, #1 Advocate.
>
> - OMB [Office of Management and Budget] - Quiet, with no pushback on the business case analysis – still have not resolved the 15 vs 9 year discount rate, but not a deal breaker. Concern with 'bargain basement' residual value of the purchase offer, and we are working with AF to reach a work around. Waiting for the political wind to establish their position.
>
> OSD – Leadership as yet uncommitted, but Pete Aldridge thought to be a supporter. Sec Roche is engaged personally with Mr. Aldridge with all the arguments we have shared. The OSD Lease Working Group is pushing back hard on the support agreement portion of the contract, disagreeing with the AF on the number of hours they can fly the 767 Tanker—due to low crew ratio. OSD is engaging with a rationale that 'AF cannot afford to operate the aging KC-135Es, but can spend more to operate the 767 at twice the flying rate - and oh by the way, AMC [Air Mobility Command] doesn't have a plan to increase the crew ration [sic] to accomplish.' We are to provide a ROM [rough order of magnitude] ASAP [as soon as possible] of a [redacted] b(4)
> [redacted] with a 'best break point for price' surge capability.
>
> Comments from Gen Essex:
>
> - AF is committed to the lease. Believe the process is slowed awaiting Sec [Secretary] Rumsfield [sic] to engage, so Mr. Aldridge is key to this process – SECAF [Secretary of the Air Force] engaged with him.
>
> - OSD staffers went to [Senators] to delay for a year. The meeting was so bad ref [reference] F-22 they didn't even bring up the proposal to delay. Senators committed to lease.
>
> - If Boeing is to engage with Congress, now is the time to keep the pressure up.
>
> - OMB is waiting for Sec [Secretary] Rumsfield [sic] to tell WH [White House] 'let's go' before they commit politically.
>
> - Desire that Boeing stay the course, as AF and Senate are sticking to the FY 06 IOC [initial operational capability] necessity.
>
> - Informal feedback from OSD is they have been told by Mr. Aldridge to **'wrap this up in two weeks.'**

On November 23, 2002, Major General Essex recommended that [redacted] be at the Office of the Secretary of Defense Leasing Review Panel meeting "which could easily turn into an ambush" because "he has answers to every question they could throw at us." Major General Essex's e-mail to Dr. Sambur regarding the Leasing Review Panel stated:

> Dr. Sambur
>
> This could easily turn into an ambush. Maybe or maybe not. In any case, I strongly advise that [redacted] should be there because he has answers to every question they could throw at us. If need be, he could go in my place. I will be just returning from TDY anyway and we could easily say he is representing me. I am not trying to avoid this meeting, but I am honest enough to admit that [redacted] is our best on this topic.
>
> Vr
>
> Bill

b(6) - OSD Redaction

On November 29, 2002, Dr. Sambur sent an e-mail to Dr. Roche about the Office of the Secretary of Defense Leasing Panel meeting with Mr. Aldridge. He stated that "The reality of the situation is that everyone is looking for a sign from the White House. If the White House wants to lease the tankers, OMB's [Office of Management and Budget's] objections will suddenly go away and their worse case views will be replaced with our more likely analysis. The delay gives the WH [White House] time to sense the political winds."

b(6) - OSD Redaction

December 2002. On December 18, [redacted] Chief of Mobility and Special Operations Forces, Weapons Systems Liaison Division, Office of Air Force Legislative Liaison [redacted] with a Representative because [redacted] sent an e-mail to Major General Leroy Barnidge, Jr., Air Force Director of Legislative Liaison in which he stated:

b(5) - OSD Redaction

> As you know, there has been some conversation about a possible meeting with [a Representative's] office (generated from the [Representative's] office through Mr. Powell Moore), OSD [Office of the Secretary of Defense] and one AF [Air Force] representative. OSD/LA [Office of the Assistant Secretary of Defense (Legislative Affairs)] [redacted] called [a congressional staffer] this morning to determine the [Representative's] desire for the meeting.

b(6) - OSD Redaction

> [redacted] This eliminates the need for a meeting in which the AF, OSD, and the [Representative's] office were going to talk about the need for tankers right now, 767 ability to fill this need, and the 767 acquisition strategy.
>
> Way Forward: Where we are at right now is that OSD at the highest levels is getting together (DepSecDef [Deputy Secretary of Defense], Mr. Aldridge, Dr. Zakheim, Powell Moore [Assistant Secretary of

b(5) - OSD Redaction

*Removed for reason stated in the initial asterisked footnote. (The references are also on pages 16 and 117.)

> Defense (Legislative Affairs)], etc) to decide the DoD way forward. The decision will be to support the lease now or show why decision should wait until a later time. I am not sure when the meeting will occur, but waiting until March (the date previously given by OSD) is no longer an option. According to [redacted] this will be decided soon and it is more now an issue of OSD explaining why DoD shouldn't do the lease then [sic] it is the AF explaining why we should (a reversal of the normal process). I will keep you posted.

On December 18, 2002, Dr. Roche stated in an e-mail that everyone knows where he and General Jumper stand on the tanker aircraft lease and that they "can look angelic" and people will "learn some civics." Specifically, Dr. Roche's e-mail to General Jumper stated that:

> The fun is to let them dangle on the hook. Pete [Aldridge] is fine, but [redacted] will learn some civics. We should be cool and let power play out. Everyone knows that you and I supported. And, Marv [Sambur] has done a super job answer PA&E's [Program Analysis and Evaluation's] petty questions one by one. [A Representative] has the con. You and I can look angelic. ☺ Jim

b(6) - OSD Redaction

On December 19, 2002, Mr. Jim Albaugh at Boeing sent an e-mail to Mr. Philip Condit at Boeing stating that he had talked to Mr. Aldridge, Dr. Roche, Dr. Sambur, a Representative, and a congressional staffer about a Novak article and had engaged the Representative's Office as well as other members. In the e-mail, Mr. Jim Albaugh stated:

> Phil, I'm sure by now that you have read the Novak piece on tankers. Since that article hit this morning we have been actively engaged in DC [District of Columbia]. I have talked to Aldridge, Roche, Sambur, [a Representative] and [a congressional staffer] on the subject [Novak Article] and we have engaged the [Representative's] office as well as other members.
>
> Aldridge's comment was that the article did not represent where OSD [Office of the Secretary of Defense] was on the tanker program. He went on to say that they did not have all the information yet needed to make a go forward recommendation. He made the point that he was concerned about [a Senator's] opposition to the program and the [he] also needed for OMB [Office of Management and Budget] to weigh in. He spoke of a series of questions that they had provided back to the AF [Air Force]. Interestingly enough in meetings with Roche, Jumper and Sambur on Tuesday, no such list of questions was mentioned. Pete [Aldridge] said that he was waiting for the AF to come back to them with answers. I told Pete we would move our team to DC and work around the clock to help if required. In addition, I told Pete that protecting cost and schedule was a growing problem for us.
>
> [A Representative], as you might suspect, is very engaged. He also called Aldridge. His read on Pete was that the program was still very alive and that Boeing needed to aggressively work with the AF to answer questions. Rudy and [a Representative] are actively working to organize [C]ongress to push on both OSD and the Administration. [The Representative] has also issued a statement basically saying that he has talked to both Aldridge and Zakheim and that the program is still under active consideration. He also says in his release that [a White House official] favors the program.
>
> In talking with Sambur, I quarried him on the list of questions for OSD. As mentioned, he had not previously mentioned any such list. It is now

in our possession and there are six questions. Some have to do with the contract and some are operational and need to be answered by the AF. Sambur also said that they were going to put out a statement refuting the Novak article.

In meeting with [a congressional staffer], he reaffirmed [a Senator's] support for the program. He has been in contact with Zakheim and I believe was very pointed in his comments on the need for OSD to work with and communicate with his committee on issues like this. [The congressional staffer's] comment also was that OSD is very concerned about the position Cambone [Mr. Steve Cambone, Under Secretary of Defense (Intelligence)] has taken on the program. [The congressional staffer] will continue to work the program on our-behalf.

Our contacts with [a Representative] indicate that he is ballistic over the article and that he takes it as a personal affront. The [Representative] met with [the White House official] earlier this week and directly raised the tanker issue and the need to get on with the deal.

I will issue a statement later today on the status on [sic] the Program. I plan on remaining in DC until Rudy and I are satisfied we have all the actions in place to get this deal done and the Novak article defused.

On December 19, 2002, Mr. Andrew K. Ellis at Boeing sent an e-mail to Mr. Jim Albaugh at Boeing in which he stated:

-- [S]poke with [a congressional staffer]. sac [Senate Appropriations Committee] very unhappy with osd [OSD (Office of the Secretary of Defense)] on this issue. [E]ngagement with osd had already begun.

-- [S]poke with [a Representative] several times. [H]e has put out a good statement. [The Representative] is working with other members, many of who are making calls to omb [OMB (Office of Management and Budget)], [W]hite [H]ouse and osd (comptroller, AT&L, L/L [Under Secretary of Defense (Comptroller); Under Secretary of Defense for Acquisition, Technology, and Logistics; and Assistant Secretary of Defense for Legislative Affairs]).

-- [a Senator] pulling together a bipartisan coalition in [S]enate to put out letter.

-- [W]e have re-engaged with [a Representative]. [N]ovak piece is a direct attack. [H]e did meet with [a White House official] earlier this week; he did raise tankers and reportedly got a positive response (undefined, at least to us) out of [the White House official].

-- [H]ave spoken with [M]arv [S]ambur several times – we are prepared to work 24/7, over the holidays, to resolve any/all open issues.

-- [W]e are also working a meeting with [S]teve [C]ambone [Under Secretary of Defense (Intelligence)] in an effort to confront head on whatever issues PA&E [Program Analysis and Evaluation] may have. [I] am prepared to take this meeting as early as tomorrow, or any day next week.

-- [A]lready speaking with senior consultants who have relationship with [Secretary] [R]umsfeld [redacted]

-- [W]hatever you need from us, or whatever else you think we can do to help, let me know. b(6)

January 2003. On January 30, Mr. Michael Montelongo, Assistant Secretary of the Air Force (Financial Management and Comptroller) sent an e-mail to

Dr. Roche in which he stated that the Office of the Secretary of Defense Leasing Review Panel decided that it was not ready to make a recommendation to the Secretary of Defense about the tanker aircraft lease proposal. In addition, he stated that the Office of Management and Budget, the Office of the Under Secretary of Defense (Comptroller), the Office of Program Analysis and Evaluation, and the Department of Defense Office of the General Counsel all lined up to give their "anti-lease" pitches, thereby leaving [redacted] only 5 minutes to offer counterpoints and make the Air Force case. He also stated that "Truly these people have not been helpful throughout the process. They've been secretive, uncooperative, obstructionist, condescending, and dismissive." Further, Mr. Montelongo stated that one issue to resonate with Mr. Aldridge was that the Air Force would not be able to get the 100-tanker aircraft lease price under a traditional procurement scenario. b(6)

On January 30, 2003, General Jumper sent an e-mail to Dr. Roche in which he discussed [redacted] interest in the tanker aircraft lease. b(5) - OSD Redaction
Specifically, in the e-mail to Dr. Roche, General Jumper stated:

[redacted]

b(5) - OSD Redaction

*Removed for reason stated in the initial asterisked footnote. (The reference is also on pages 17, 120, and 210.)

[redacted] b(5) - OSD Redaction

On January 31, 2003, Lieutenant General Joseph H. Wehrle, Jr., Air Force Assistant Vice Chief of Staff reported that Mr. Aldridge, after a bit more analysis (cost of buying tankers at the same rate versus leasing them), is going to support the lease. He plans to send the recommended approval to Office of Management and Budget and, if they disagree, have them argue with the White House. In an e-mail to Dr. Roche; General Jumper; and General Robert Foglesong, Air Force Vice Chief of Staff; Lieutenant General Wehrle stated:

> Sirs: At a formal function last evening honoring Sec [Secretary] Aldridge, he told me that after a bit more analysis (cost of buying tankers at the same rate vs. leasing them), he is going to support the lease. He mentioned [redacted] to by vs. 1 purchased tanker at the end of the FYDP [Future Years Defense Program]. His plan is to send the recommended approval to OMB [Office of Management and Budget] and if they disagree, have them argue with the WH [White House]. This involvement corresponds with interest from new WHMO [White House Military Office] chief (RADM [Rear Admiral] Miller) who asked me how the lease was coming. I passed this info to Marv [Sambur] who was at the ceremony. . . his folks are engaged with AT&L [Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics] already.
>
> VR Joe

b(4) - OSD Redaction

On January 31, 2003, Dr. Roche commented that he thinks that he finally got to Mr. Aldridge by focusing on the unique opportunity Congress has given the Air Force concerning the tanker aircraft lease. In an e-mail to General Jumper, General Foglesong, Lieutenant General Wehrle, Dr. Roche stated:

> Joe, good for you. I think I finally got to Pete [Aldridge] yesterday pm by focusing on this unique opportunity Congress has given us (with Marv's [Sambur] point that no one is giving us the top line money to by [sic] all 100 [tanker aircraft] at one shot). I also reviewed the lease deal with [a Senator], who, as with Gen [General] Jumper, continues to wonder why the Administration doesn't understand the goodness of this situation. JGR

February 2003. On February 11, [redacted] Office of Management and Budget told Mr. Michael W. Wynne, Principal Deputy Under Secretary of Defense for Acquisition, Technology, and Logistics that he believed that some of the arguments surrounding the tanker lease have been mischaracterized. In an e-mail to Mr. Wynne, [redacted] stated:

b(6) - OSD Redaction

> This is in reply to your e-mail which, in our view, mischaracterized some of the arguments surrounding the tanker lease.
>
> Aircraft Quantity: The Air Force can obtain the same quantity (number) of aircraft within the FYDP [Future Years Defense Program] for a lease as it can with a direct purchase. It is merely a question of willingness to

*Removed for reason stated in the initial asterisked footnote. (The reference is also on pages 17, 120, and 210.)

> put funding resources behind the program (something the Air Force chose not to do in its POM [Program Objectives Memorandum] or budget for FY 2004), which is usually a good indicator of a Services' priority for a program. If, however, by "quantity" you mean tanking capacity over the FYDP, this capacity will actually be decreased under the Air Force's plan.
>
> Lease Costs: Although leasing tankers may not require as much up front funding, and therefore requires less over the FYDP, leasing is more expensive than direct purchase. That is, in the end, the government will pay more for these tankers through a lease than a direct purchase. Both OMB [Office of Management and Budget] and PA&E [Program Analysis and Evaluation] analyses show this. All leasing does is phase the dollars differently.

On February 21, 2003, Dr. Sambur reported to senior Defense officials that the tanker aircraft lease would place the entire cost performance burden on the contractor while delivering the savings of a multiyear contract to the Government from day one. However, he did not mention that the Air Force needed to obtain a waiver for lease termination liability that would peak at about [redacted] in FY 2007 and that the lease would be for only 6 years over which time the Air Force would be required to pay 90 percent of the fair market value of aircraft. In a memorandum, "KC-767 Lease Proposal," February 21, 2003, to Mr. Aldridge and Dr. Zakheim, Under Secretary of Defense (Comptroller) with a cc: to Dr. Spruill, Director, Acquisition Resource and Analysis, Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics; and Dr. Schroeder, Deputy Under Secretary of Defense (Resource Planning/ Management), Dr. Sambur stated that:

> The Air Force's proposal to lease 100 KC-767s has truly been a 'learning journey' for all of us that have been working this new and innovative approach to acquiring needed capability for our warfighters. Throughout the review process, the OSD [Office of the Secretary of Defense] and OMB [Office of Management and Budget] staffs have challenged us with many thought-provoking questions, several of which have caused us to look deeper into the unique characteristics of leasing. One of these characteristics that seemed only secondary at first has now emerged as a significant, primary lease advantage: the multiyear nature of the contract itself.
>
> [redacted]

b(5)

[redacted]

b(5)

On February 23, 2003, [redacted] **sent an e-mail to Major General Essex in which he stated that, if the KC-767A tanker aircraft goes into production via the lease, it will continue to get funding as long as there are no serious technical problems and many decision makers will probably consider it a continuous "must pay" bill.** The e-mail stated: b(6) - OSD Redaction

> Sir,
>
> The following is my look at this issue through a "political framework:"
>
> The decision to end a production line has as much to do with maintaining the defense industrial base (a DoD concern) and jobs (a Congressional concern) as it does with force structure needs (a concern of both).
>
> Once an acquisition program goes into production, it is very hard to terminate early—not because of sunk costs (a popular myth), but rather because it has then become part of the industrial base and jobs infrastructure.
>
> Even as an acquisition program reaches its pre-planned ending point, it can be difficult to actually shut down. Decisionmakers know it is generally impractical to re-open a closed production line; therefore, a decision to stop production is very final – you cannot change your mind in a year or two if the world changes. Unless a replacement is in the wings (signaling an industrial base/jobs/force structure shift, but not a net loss), or the program is unpopular (technical difficulties, high expense, etc), the ending point may turn into a gradual decline in production rates rather that a "cold turkey" shut off.
>
> Conclusions:
>
> As long as C-17 continues to be considered a high-value asset, has no replacement identified, and continues to reduce costs, it will likely continue to get funding up to the point where the operational need has unquestionably been met.

> If KC-767 goes into production via the lease, it will also continue to get funding as long as it does not exhibit serious technical problems when first fielded. Once KC-135 recapitalization starts, many decisionmakers will probably consider it a continuous "must pay" bill.
>
> Therefore, with both of these high-value programs in simultaneous production, funded by a MAJCOM [major command] that may not be able to fund them both after 2009, there is just as much likelihood that AMC [Air Mobility Command] will see a TOA [Total Obligation Authority] increase as the alternative decision to close C-17 or KC-767. Put another way, the C-17 decision will not necessarily be a function of KC-767. If it were, KC-767 recapitalization would be delayed not just a few years – it would be delayed indefinitely.

On February 28, 2003, Dr. Sambur sent an e-mail to Dr. Roche and General Jumper in which he stated that the Office of the Secretary of Defense Leasing Panel was converging toward supporting the Air Force position on the tanker aircraft lease. Specifically, the e-mail stated:

> Boss, Chief The Leasing panel is converging towards supporting the AF [Air Force] position. We have no debate on whether we have a need and consensus that re-engining is NOT the way to go. There is a recognition that leasing gets us the tankers soonest given budget realities and that the AF can afford the lease in the FYDP [Future Years Defense Program]. There is still a debate on the OMB [Office of Management and Budget] issues, but Dov [Zakheim] is now coming around to kicking the can to OMB. [Mr.] Aldridge is already there.

On February 28, 2003, the Office of the Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition) provided a briefing on the KC-767A lease proposal to the Office of the Secretary of Defense Leasing Review Panel. They briefed that the lease purchase analysis showed that the net present value favoring the lease over the purchase by $863.8 million using various assumptions and a non-multi year purchase adjustment to meet Office of Management and Budget Circular No. A-94 requirements.

March 2003. On March 6, the Office of the Secretary of Defense Leasing Review Panel issued a memorandum that addressed:

- **Institute for Defense Analyses Report.** The study showed a conservative estimate of [redacted] (FY 2002 dollars) per aircraft for 100 aircraft [redacted] for green aircraft, [redacted] for modification, and [redacted] for recurring costs). The aggressive estimate was [redacted] The Air Force agreed to work with the Institute for Defense Analyses to address differences. b(5)

- **Department of Defense Office of the General Counsel Report.** The Department of Defense Office of the General Counsel indicated that parties could resolve legal issues but additional risk would shift to the Government.

- **Office of Management and Budget Report.** The Office of Management and Budget reported that the tanker aircraft lease was the largest and most complex in the history of the Office of Management

and Budget Circular No. A-94 and had the potential to set future precedence. At that time, no Circular precedence existed for leasing when purchasing was less expensive. The Office of Management and Budget stated that, if a termination liability waiver was not obtained, the lease was not affordable. In addition, the Office of Management and Budget reported another precedent setting issue relating to using a rolling discount rate for the Circular analysis. The Air Force agreed to work the issues with the Office of Management and Budget and the Department of Defense Office of the General Counsel.

On March 7, 2003, [redacted] provided an update on the Boeing KC-767A tanker aircraft lease decision to Dr. Sambur, Major General William Hodges, Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition) in which he stated that "IDA [Institute for Defense Analyses], Boeing, and the Air Force met this morning to discuss cost estimate differences. Boeing's bases of estimate were very strong in face of IDA's relatively weak rationale." b(6) - OSD Redaction

May 2003. On May 2, [redacted] sent an e-mail to Dr. Sambur in which he stated that he met with Mr. Aldridge; Vice Admiral Stanley Szemborski, Principal Deputy Director, Program Analysis and Evaluation; and their staff on the Boeing KC-767 tanker aircraft lease. The outcome was that Mr. Aldridge would sign out a decision that authorized the Air Force to proceed with a lease program and that asked the Office of Management and Budget to waive the termination liability for the tanker aircraft lease. Specifically, [redacted] stated in the e-mail that: b(6) - OSD Redaction

> I met this afternoon with Pete Aldridge, VAdm [Vice Admiral] Szemborski and their staffs concerning KC-767 lease. The outcome was a decision to be signed out by Pete (as an Acquisition Decision Memo) authorizing the AF [Air Force] to proceed with a lease program and asking OMB [Office of Management and Budget] to waive termination liability. He will also direct a unit price of about [redacted] below our current position), but will allow us to craft a cost-plus arrangement for the tanker modification. We believe this is do-able within a lease contract and, though out of the box, should be acceptable to Boeing. b(4) - OSD Redaction
>
> This will allow us to proceed without cutting content and at a price that matches the OMB/IDA [Office of Management and Budget/Institute for Defense Analyses] estimate, but only if we can shift cost risk for that estimate to the government. In essence, if OSD [Office of the Secretary of Defense] believe the IDA estimate and isn't willing to pay Boeing to assume the risk of a fixed-price contract, then OSD should be willing to assume it through a cost-plus contract. I think we'll have full support of AT&L [Acquisition, Technology, and Logistics], PA&E [Program Analysis and Evaluation] and Comptroller for this course of action (they predicted OMB support as well).
>
> There are going to be plenty of details to work out in the coming weeks, but this looks like a win-win decision to me.

On May 12, 2003, financial advisors provided an analysis showing that the financing subsidy for the tanker aircraft lease was worth from [redacted] to [redacted] per plane depending on market rate assumptions. On that date,

b(4) - OSD Redaction

[redacted], sent an e-mail to [redacted] System Program Director, KC-767 System Program Office that was later forwarded to Major General William Hodges and [redacted] In the e-mail, [redacted] stated:

> [redacted] I have attached a short analysis of the per plane value of the B Note (G+100) subsidy at various interest rates. We spoke with [redacted] today and they indicated that they have not updated their estimate of the market interest rate for this tranche for several months. Consequently, we have used the old range of assumed rates of 10%, 12.5%, and 15% for this analysis. We have asked [redacted] to provide us with an updated view on the market rate for this tranche as soon as possible. This analysis shows that the subsidy is worth from [redacted] to [redacted] per plane depending upon these assumed market rate assumptions.
>
> As you and I have discussed, while this Boeing plane may be the ideal plane for the USAF [U.S. Air Force] tanker needs, it may not have the same utility/value for commercial use. The new and used market for commercial aircraft, both passenger and freighter, in the world is perhaps at an all-time low. This combined with the fact that the B767 is about to go out of production means that potential B not investors may not get much comfort in the collateral value of the asset that they are being asked to finance. I also doubt that it will be possible to convince them that a sizeable "used" tanker market exists for this plane, particularly in the circumstances where the USAF is rejecting the plane. In our opinion, these are good reasons to have interest rate insurance policy that the subsidy provides.
>
> We recognize that there is an active effort underway to close the gap on the price for these planes, and perhaps a desire to obtain the lowest price possible from Boeing --- even if that means eliminating the B note subsidy. Our recommendation is to keep that subsidy as part of the deal, or at least to give the Air Force the option to take it and pay Boeing a higher price for the planes (offer an extra [redacted] per plane). Even if a monocline wrap is ultimately utilized, the current business deal is that the financial terms of that new monocline financing must be at least as good for the Air Force as the current financing structure, which includes the subsidized B note rates.
>
> Three years from now when the first of these planes is ready to go in service and the permanent financing is being solicited, I doubt that anyone will remember if the acquisition price in 2002 dollars was, to use an example, [redacted] or [redacted] However, if the market rate on the B not gets priced at rates above 10% and the least term is shortened to 5 years, people will take notice.

b(6) - OSD Redaction

b(4) - OSD Redaction

b(4) - OSD Redaction

On May 14, 2003, [redacted] Program Budget and Congressional Division, Office of the Director of Global Reach Programs, Office of the Assistant Secretary of the Air Force (Acquisition) sent an e-mail to the Office of the Director of Global Reach Programs staff in which he stated that a Senator was questioning the Secretary of Defense on the tanker aircraft lease issue and that a Senator repeated that a further delay was unconscionable. In the e-mail, [redacted] discussed a Senate Appropriations Committee hearing with the Secretary of Defense on May 14, 2003, and stated:

b(6) - OSD Redaction

> Of direct interest to AQQ [Office of the Director of Global Reach Programs] was the question/answer session between [a Senator] and SECDEF [Secretary of Defense] on the tanker lease issue. [The

Senator's] question centered around the delay in reaching a decision on the KC-767 lease vs buy issue. He framed his question in a strongly worded statement that addressed the age of the KC-135 tankers, the decay and corrosion, that after a year of repair the aircraft were still unfit to fly and the danger to the airmen flying them. He invited the SECDEF, his advisors and outside experts to Tinker AFB [Air Force] to see for themselves the condition of the aircraft. He closed by saying "They are old and need to be replaced. Further delay is unconscionable."

SECDEF responded by saying that DoD was breaking new ground here in looking at a leasing deal of this size. He described the lease proposal as 125 pages long with at least 80 clauses. He wanted a through outside look. He said we were still trying to negotiate a proper price.

[The Senator] repeated, again, further delay was unconscionable.

On May 16, 2003, [redacted] reported in an e-mail to Major General William Hodges that the KC-767 System Program Office continues to pursue the Boeing KC-767A tanker aircraft lease deal with zero risk-tolerance even though the Office of the Secretary of Defense is saying otherwise. "The key here (and apparently missed by the SPO [System Program Office]) is that OSD [Office of the Secretary of Defense] wants to lower the price and assume more risk and that's what removing the subsidy does." In the e-mail, [redacted] stated:

b(6) - OSD Redaction

Sir,

I had [redacted] assessment along with Dr M's before I made my own. [redacted] didn't say the rate would be 10-15%, they just said what the impact would be if it got that high and factors that might cause it to be that high.

b(4) - OSD Redaction

Three questions you might ask the [redacted] [System Program Office/ [redacted] (for which I've given you my own opinion already):

1) "Can you give me examples of 6-yr bonds that are trading today at 10-15% interest rate and an assessment of how their risk is comparable to ours?"

2) "Since the perceived risk is tied so closely to the chance of AF [Air Force] returning the aircraft at the end of the lease, how would the AF's purchase of some of the KC-767s prior to delivery (as early as the first lot) affect the B-tranche interest rate?"

3) " Do you think the rate will go down or up as deliveries progress – i.e., is your prediction of 10-15% a peak or average rate?"

The SPO continues to pursue this deal with zero risk-tolerance even though OSD is saying otherwise. Much like our cost estimates, the B-tranche interest rate estimate is just a prediction. The higher the estimated rate you use, the lower the risk you'll be surprised in the future – that's why the SPO wants a high number. That's also why they want to assume a higher-than-official inflation rate (3.3% instead of 1.8%) and a large budget for [redacted]. But it's up to the executive decisionmakers to decide what they want for a unit price (a question of contractual risk) and how much to put in the budget (a question of budget risk). It looks like the SPO would like these to be the same, but they don't have to be (Mr. Aldridge so told Dr. Sambur and I two weeks ago). The SPO's attempt to push the price (rather than the budget) back up to lessen the risk could be very counterproductive to getting approval for the deal in the first place.

b(4) - OSD Redaction

The key here (and apparently missed by the SPO) is that OSD [Office of the Secretary of Defense] wants to lower the price and assume more risk and that's what removing the subsidy does.

V/R,

b(6) - OSD Redaction

[redacted]

On May 19, 2003, Mr. Jack House at Boeing sent an e-mail to Mr. John Ferguson at Boeing about a discussion Mr. Bob Gower at Boeing had with Dr. Sambur, who said that the plan was to get the Deputy Secretary of Defense to approve the tanker aircraft deal on Tuesday. "USAF will then use the political process to work OMB and get the lease through Congress." He believed that profit cap will work and that Boeing did not need to change price.

On May 22, 2003, Mr. Andrew Ellis at Boeing stated in an e-mail that Ms. Robin Cleveland, Office of Management and Budget, called to tell him that "deal done." Further, he stated that Ms. Cleveland stated that another Office of Management and Budget official was okay in her view even though he was on his way out the door. She was complimentary of Boeing and said much of the problems were with the Air Force. Further, she stated that the view of the deal was 200 tankers and that it may be a $35 billion plus deal with some additional political work.

On May 23, 2003, Mr. Michael Wynne, Principal Deputy Under Secretary of Defense for Acquisition, Technology, and Logistics recalled that Mr. Aldridge announced at a press conference that the Government was going forward with the lease for 100 Boeing KC-767A tanker aircraft.

June 2003. On June 10, Dr. Sambur sent an e-mail to Dr. Roche in which he stated that Ms. Robin Cleveland wanted all the operating lease issues "pristine" and if not, the Air Force had to get a waiver from Congress. Specifically, Dr. Sambur stated:

> Boss
>
> We had the meeting and Robin had 2 points:
>
> - She wanted to make sure that we were "pristine" with All (operating lease) issues and if not we had to go to Congress for a waiver
>
> - She wanted the $2B [billion] that [Mr.] Aldridge promised to pay down the lease.
>
> I countered that we showed that we passed [Office of Management and Budget Circular] A-11 and that if we had to go for a waiver, the lease would be killed. [redacted]

b(5) - OSD Redaction

> [Mr.] Wynne, to his credit, said that the $2B [billion] was a separate issue from the lease. [Ms.] Robin [Cleveland] pushed back but Wynne held firm.

*Removed for reason stated in the initial asterisked footnote.

> I have my PEO [Program Executive Officer] and DAC [Designated Acquisition Commander] reviews this morning and afternoon. Gen [General] Hodges will be attending.
>
> Marv

On June 20, 2003, Mr. Kenneth J. Krieg, Director, Program Analysis and Evaluation sent a memorandum to Mr. Wynne, Acting Under Secretary of Defense for Acquisition, Technology, and Logistics and Dr. Zakheim in which he stated in part that:

> Our A-94 analysis indicates that the provisions of the draft KC-767A aircraft lease cost more than the equivalent purchase of tanker aircraft. Measured in then-year dollars, lease costs exceed purchase costs by $6.0B [billion]; by $5.1B [billion] if measured in constant FY02 dollars; or by $1.9B [billion] if measured in terms of net present value. Our A-94 analysis is based on the following key assumptions: 1) For the leasing scenario, that the Department purchases the KC-767A tanker aircraft at the end of the lease period; and 2) for the direct purchase scenario, that the Department seeks and receives Congressional approval for a multiyear procurement of 100 aircraft. We find that leasing provides no inherent economic efficiencies relative to direct purchase of tankers and is, therefore, more expensive in the long run.
>
> Our analysis also shows that the current draft lease fails to meet the requirement of OMB [Office of Management and Budget] Circular A-11 that the present value of the lease payments be less than 90 percent of the fair market value at lease inception. Our calculations show that lease payments are more than 93 percent of fair market value, exceeding the requirements for the definition of an operating lease. This analysis is based on a fair market value of $131 million (CY02$). In addition to OMB Circular A-11 requirements, Section 8159 of the FY02 appropriations act includes a requirement that the present value of the lease payments be less than 90 percent of the fair market value at lease inception.

On June 23, 2003, Mr. Thomas Owens at Boeing sent an e-mail to Mr. Jim Albaugh at Boeing in which he stated that Dr. Roche, Secretary of the Air Force, asked us to put pressure on Mr. Wynne to have Mr. Krieg change his position on the Boeing KC-767A tanker aircraft lease.

July 2003. On July 3, Dr. Sambur stated in an e-mail to Dr. Roche that the tanker aircraft lease report to Congress has left the building for final approval by the Office of Management and Budget and assurance of a waiver of the termination liability. Further, he stated that the Office of Management and Budget and the Office of Program Analysis and Evaluation were not happy with a comparison between a lease and a traditional buy. Instead, if the Air Force use a multiyear procurement for comparison, it would heavily favor a buy. Specifically, Dr. Sambur stated:

> Boss
> It left the building (after an agreed version between OSD [Office of the Secretary of Defense] and the AF [Air force]) for OMB's [Office of Management and Budget's] final blessing and assurance of a waiver of termination. They (OMB and PA&E [Program Analysis and Evaluation]) are now OK with my A-11 interpretation (the [redacted] [million] is not the price at time of delivery) but PA&E and OMB (Robin [Cleveland]) are unhappy with the use of a lease comparison

b(4) - OSD Redaction

with a traditional buy (which is a wash). If we use MYP [multiyear procurement] purchase for comparison, it is heavily favored towards a buy. AT&L [Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics] and OSDC [Office of the Under Secretary of Defense (Comptroller)] have come over to our side. If all goes well you sign and we deliver to Congress. Have a Happy 4th!
Marv

October 2003. On October 9, Dr. Sambur stated in an e-mail to [redacted] Office of Management and Budget that he was concerned about changes to Office of Management and Budget Circular No. A-11 that clarified the criteria for qualifying for an operation lease and the inference that the tanker aircraft lease squeezed by on a "loophole." Specifically, Dr. Sambur stated:

[redacted]

b(6) - OSD Redaction

I am worried about the answer in which it is stated that

- In July 2003, as part of our annual revision to Circular A-11, OMB [Office of Management and Budget] prospectively tightened and clarified the criteria for qualifying as an "operating lease." This change should help to ensure that long-term leases of capital equipment remain the exception rather than the rule.

Does this statement not beg the question as to whether you changed the circular because the tanker lease squeezed by on a "loophole" in the old circular and would not pass the new circular? Is this not a bad inference for the lease?

Marv Sambur

November 2003. On November 24, in Section 135 of the National Defense Authorization Act for FY 2004, Congress limited the number of tanker aircraft that the Air Force could lease to 20 and authorized the procurement of up to 80 tanker aircraft. In addition, Section 135 required the Secretary of Defense to perform a study of long-term aircraft maintenance and requirements. Specifically, Section 135 stated:

Sec. 135. PROCUREMENT OF TANKER AIRCRAFT.

(a) LEASED AIRCRAFT – The Secretary of the Air Force may lease no more than 20 tanker aircraft under the multiyear aircraft lease pilot program referred to in subsection (d).

(b) MULTIYEAR PROCUREMENT AUTHORITY – (1) Beginning with the fiscal year 2004 program year, the Secretary of the Air Force may, in accordance with section 2306b of title 10, United States Code, enter into a multiyear contract for the purchase of tanker aircraft necessary to meet the requirements of the Air Force for which leasing of tanker aircraft is provided for under the multiyear aircraft lease pilot program but for which the number of tanker aircraft leased under the authority of subsection (a) is insufficient.

(2) The total number of tanker aircraft purchased through a multiyear contract under this subsection may not exceed 80.

(3) Notwithstanding subsection (k) of section 2306b of title 10, United States Code, a contract under this subsection may be for any period not in excess of 10 program years.

(4) A multiyear contract under this subsection may be initiated or continued for any fiscal year for which sufficient funds are available to pay the costs of such contract for that fiscal year, without regard to whether funds are available to pay the costs of such contract for any subsequent fiscal year. Such contract shall provide, however, that performance under the contract during the subsequent year or years of the contract is contingent upon the appropriation of funds and shall also provide for a cancellation payment to be made to the contractor if such appropriations are not made.

(c) STUDY OF LONG-TERM TANKER AIRCRAFT MAINTENANCE AND TRAINING REQUIREMENTS-(1)- The Secretary of Defense shall carry out a study to identify alternative means for meeting the long-term requirements of the Air Force for—

(A) the maintenance of tanker aircraft leased under the multiyear aircraft lease pilot program or purchased under subsection (b); and

(B) training in the operation of tanker aircraft leased under the multiyear aircraft lease pilot program or purchased under subsection (b).

(2) Not later than April 1, 2004, the Secretary of Defense shall submit a report on the results of the study to the congressional defense committees.

(d) MULTIYEAR AIRCRAFT LEASE PILOT PROGRAM DEFINED- In this section, the term 'multiyear aircraft lease pilot program' means the aerial refueling aircraft program authorized under section 8159 of the Department of Defense Appropriations Act, 2002 (division A of Public Law 107-117; 115 Stat. 2284).

(e) SENSE OF CONGRESS- It is the sense of Congress that, in budgeting for a program to acquire new tanker aircraft for the Air Force, the President should ensure that sufficient budgetary resources are provided to the Department of Defense to fully execute the program and to further ensure that all other critical defense programs are fully and properly funded.

March 2004. On March 29, the Department of Defense Office of the Inspector General issued Report No. D-2004-064, "Acquisition of the Boeing KC-767A Tanker Aircraft," stating that:

> The contract lease for 20 Boeing 767A tanker aircraft did not meet three of six criteria requirements for an operating lease as described in OMB [Office of Management and Budget] Circular No. A-11. Meeting the OMB criteria for leases is a statutory requirement of Section 8159 of the Department of Defense Appropriations Act for FY 2002. Further, the Air Force long-term lease is contrary to the actual intended use of operating leases, which may be cost effective when the Government has only a temporary need for the asset. Accordingly, the lease for the Boeing KC-767A Tanker Program was incorrectly classified as an operating lease.

The three criteria not met were:

- the asset is a general-purpose asset rather than being for a special purpose of the government and is not built to the unique specification of the government as lessee;

- there is a private-sector market for the asset; and
- the lease does not contain a bargain-price purchase option.

October 2004. On October 28, in Section 133 of the "Ronald W. Reagan National Defense Authorization Act for Fiscal Year 2005," Congress terminated the Secretary of the Air Force authority to lease tanker aircraft; however, it authorized the procurement of up to 100 tanker aircraft. Specifically, Section 133 stated:

> SEC. 133. AERIAL REFUELING AIRCRAFT ACQUISITION PROGRAM.
>
> (a) TERMINATION OF LEASING AUTHORITY.—Subsection (a) of section 135 of the National Defense Authorization Act for Fiscal Year 2004 (Public Law 108–136; 117 Stat. 1413; 10 U.S.C. 2401a note) is amended by striking "may lease no more than 20 tanker aircraft" and inserting "shall lease no tanker aircraft".
>
> (b) MULTIYEAR PROCUREMENT AUTHORITY.—Subsection (b) of such section is amended—
>
> (1) in paragraph (1)—
>
> (A) by striking "Beginning with the fiscal year 2004 program year, the Secretary" and inserting "The Secretary"; and
>
> (B) by striking "necessary to meet" and all that follows through "is insufficient";
>
> (2) in paragraph (2), by striking "80" and inserting "100"; and
>
> (3) by striking paragraph (4).
>
> (c) STUDY.—Subsection (c)(1) of such section is amended by striking "leased under the multiyear aircraft lease pilot program or" in subparagraphs (A) and (B).
>
> (d) RELATIONSHIP TO PREVIOUS LAW.—Such section is further amended by adding at the end the following new subsection:
>
> "(f) RELATIONSHIP TO PREVIOUS LAW.—The multiyear procurement authority in subsection (b) may not be executed under section 8159 of the Department of Defense Appropriations Act, 2002 (division A of Public Law 107–117).".